



Problem Loan Management
Participant Guide

November 2001

Problem Loan Management

Course Description

Loans that get into trouble bring both direct and indirect losses to the banks. The purpose of this course is to examine the causes of the problem loans and the procedures that can be instituted to manage them effectively. Topics include corporate crisis situations, warning signals, and policies that the bank can use to recover bad debts. Case studies are used to highlight the points and issues brought out in the course.

Target Audience

This seminar is designed for managers and senior-level officers responsible for loan review and problem loan administration; bank legal department staff and managers responsible for problem loan documentation, workout situations, and receivership management.

Prerequisite

Credit-related work experience highly desirable.

Course Topics

This seminar covers a range of topics associated with problem loan management, including:

- ◆ Introduction and Overview of Risk Management;
- ◆ Causes of Company Failure;
- ◆ Warning Signals;
- ◆ Financial Distress Characteristics;
- ◆ Predicting Business Failure;
- ◆ Cash Flow Analysis;
- ◆ The Bank and Workout Situations;
- ◆ General Recovery Strategies;
- ◆ Types of Recovery Situations;
- ◆ Characteristics of Successful Recovery Strategies;
- ◆ Valuing a Business in Liquidation; and
- ◆ Steps in Problem Loan Management.



Unit 1 :
Overview and Objectives

Ice Breaker

- What is your name?
- What is one interesting thing about your professional experience?
- What are your expectations of this course?

Purpose

- Participants will discuss how to apply the key elements of the Problem Loan Management Course to their jobs.

Objectives

At the end of this unit, participants will be able:

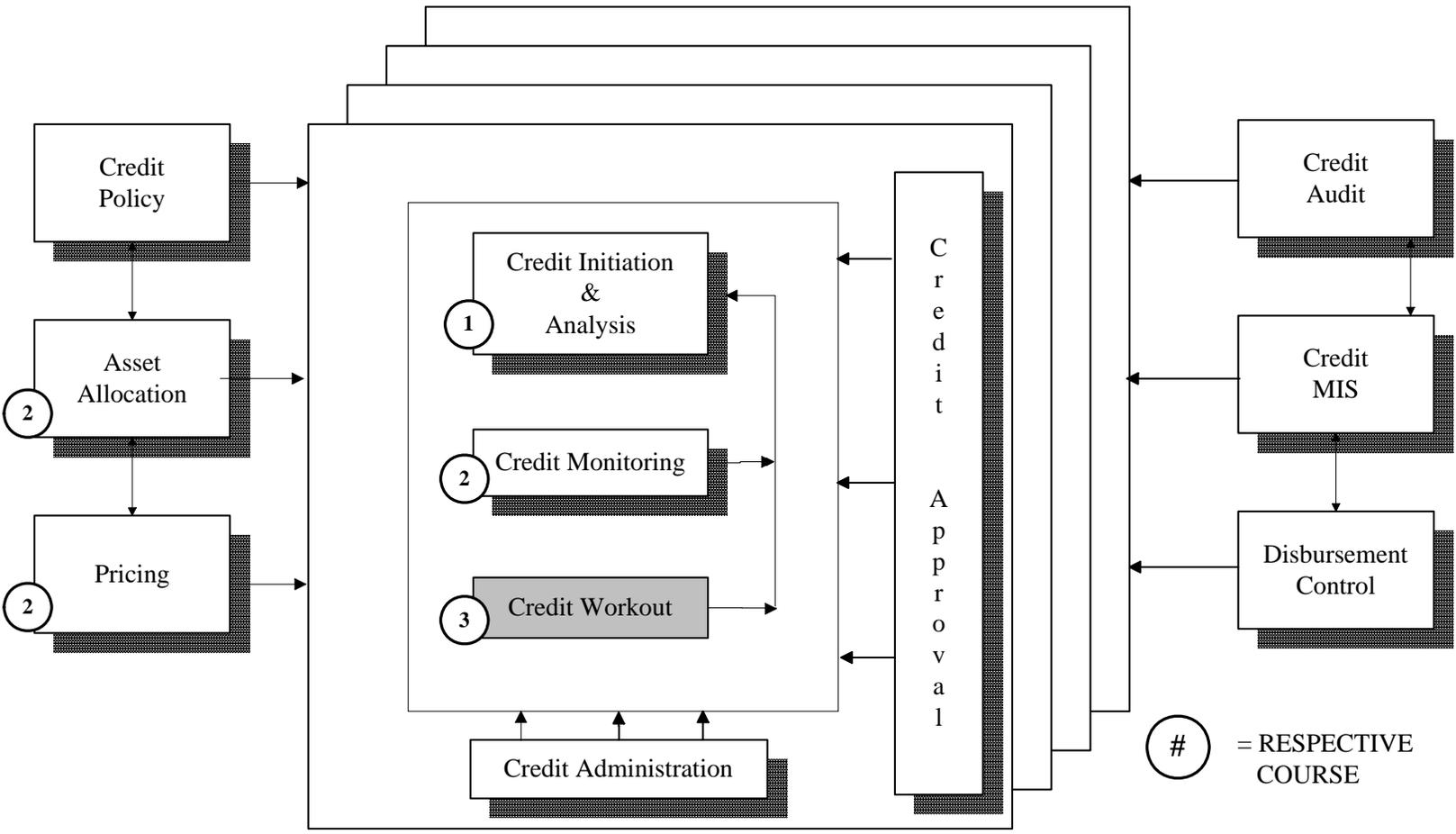
1. Describe the objectives of problem loan management and the framework guiding the process.

CREDIT MANAGEMENT SYSTEM

Portfolio Management

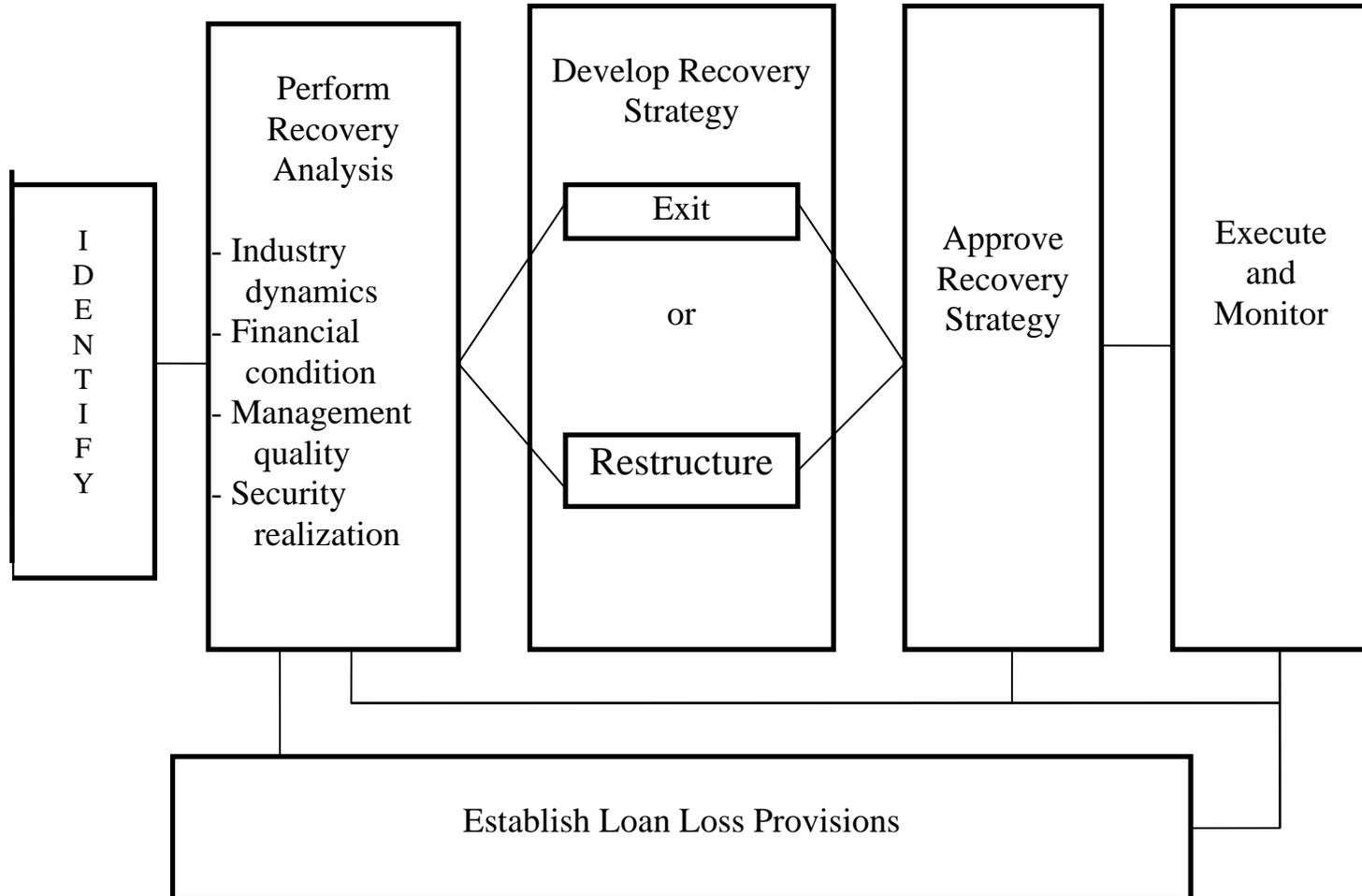
Relationship Management

Control Management



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Problem Loan Recovery Process



Problem Loan Management

Unit 1 Overview and Objectives

Unit 2 Problem Loan Identification

Unit 3 Recovery Analysis

Unit 4 Recovery Strategy

Unit 5 Recovery Strategy Approval

Unit 6 Strategy Execution and Monitoring

Unit 7 Case Study Discussion

Unit 8 Summary

Overview of Content Within Each Unit

- Unit 1 - Introduction to course
- Unit 2 - Identify problem loans and how to manage transfer of problems loan
- Unit 3 - How to assess creditworthiness of problem loans to determine recovery strategy
- Unit 4 - Outline how to formulate problem loan recovery strategy and action plan to implement strategy
- Unit 5 - How to prepare a recovery strategy package and obtain approval of package
- Unit 6 - How to promptly identify and address recovery problems
- Unit 7 - Discusses the case as developed in the course
- Unit 8 - Summary of course

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Unit 2:
Problem Loan Identification

Purpose

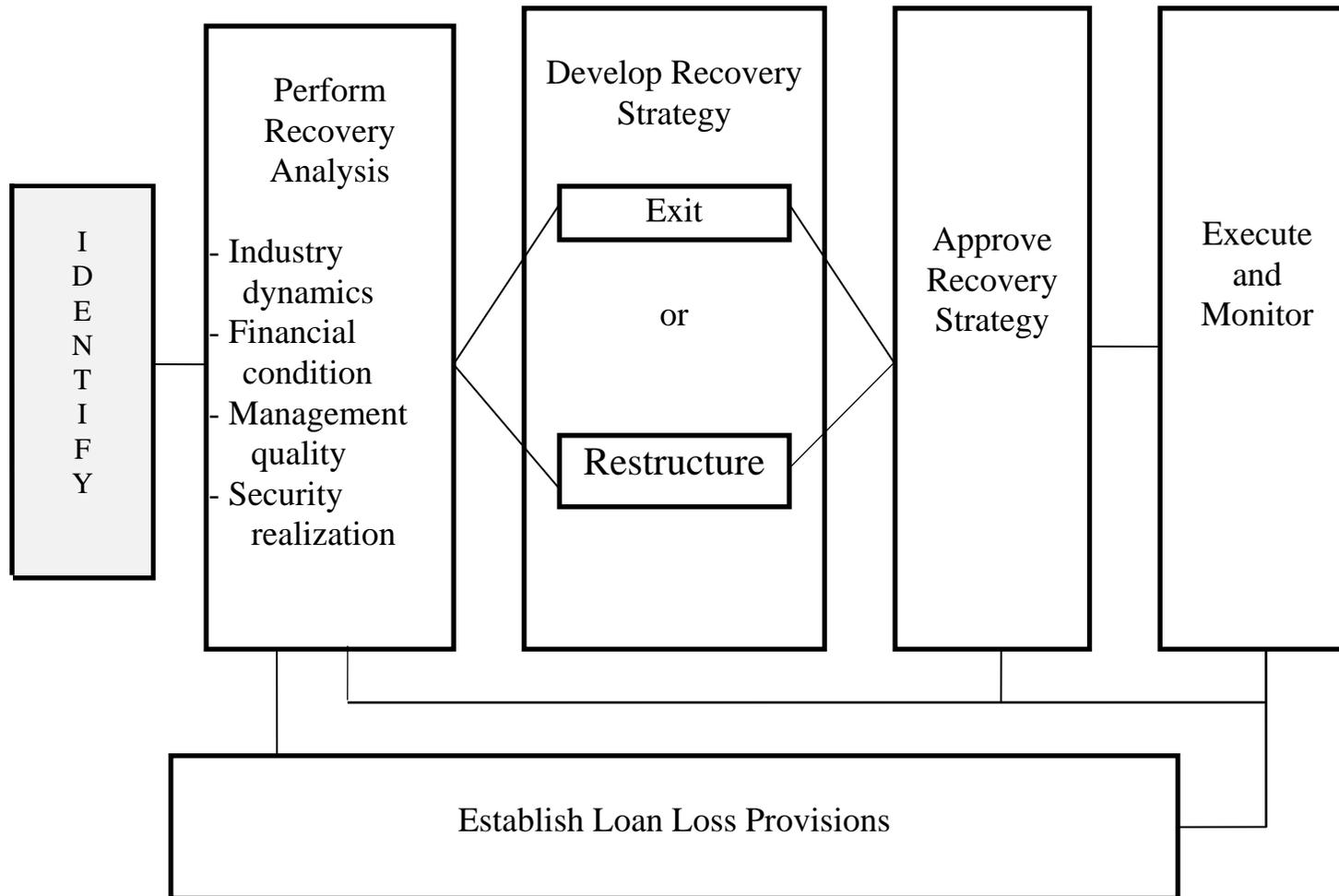
You will learn how to identify problem loans early and how to manage the problem loans.

Objectives

At the end of this unit, you will be able to:

1. Identify problem loans early.
2. Ensure problem loans are managed by appropriate resources.
3. Ensure additional exposure incurred is controlled to the advantage of the bank.

Problem Loan Recovery Process



Examples of Warning Signs and Data Gathering

FOUNDATION	WARNING SIGNS	DATA REQUIRED
Industry Dynamics	<ul style="list-style-type: none"> • Laws Change • Increase competition 	<ul style="list-style-type: none"> • Legislative notices • Price levels, list of new competitors
Financial Condition	<ul style="list-style-type: none"> • Unable to meet interest payment • Poor account fluctuation 	<ul style="list-style-type: none"> • Payment status, Debt service ratio • Account fluctuation from branch
Management Quality	<ul style="list-style-type: none"> • Significant staff turnover • Turnover of key executive/owners 	<ul style="list-style-type: none"> • Staff levels/new hiring • Executive rosters
Security Realization	<ul style="list-style-type: none"> • Decline in executability • Decline in control 	<ul style="list-style-type: none"> • Time required to execute security • Inventory and A/R's levels

Monitoring Data Collection

Ability to service debt is a key measure of creditworthiness.

- Key tangible way to measure liquidity and financial condition

- May lead to weakness in other credit foundations
 - Industry Dynamics
 - Financial Conditions
 - Management Quality
 - Security Realization

Required Actions for Non-Payment

Internal	External
<ul style="list-style-type: none">• Notify department management	<ul style="list-style-type: none">• Call customer and request payment within 7 days
<ul style="list-style-type: none">• If not corrected within 15 days, notify credit committee and downgrade classification <p>By law in Poland, if not paid in 30 days, reclassify</p>	<ul style="list-style-type: none">• Increase monitoring<ul style="list-style-type: none">- Update creditor calls- Increase customer calls- Check collateral

Customer Calls & Site Visits

Conduct customer calls and site visits to obtain key data.

- Problems are often evident here first
- Problems are often disguised in financial statements

Conduct customer call quarterly.

- Develop a call schedule plan
- Plan other necessary data gathering

Customer Classification Plan

A standard customer classification system:

- Identifies and isolates early warning signs and triggers corrective action
- Prompts officers to draw conclusions regarding creditworthiness
- Provides a basis for controlling and managing the monitoring process
- Standardizes the measurement of risk and creates a common language for addressing credit issues

Standards for Classifying Loans

Classify loans based on a set of standard guidelines.

Classification of credits is a subjective exercise.

- Financial statements and tools can often be misleading and inaccurate.
- Many required measurements are clearly judgmental.

Classifications Definitions

Low Risk	Relationships that represents minimal risk, all credit components are strong now in the foreseeable future
Acceptable Risk	Relationships that represent satisfactory risk with no material weakness apparent
Moderate Risk	Relationships where one or more credit components are weak; although no immediate loss is evident, close monitoring is required
High Risk	Relationships where material weaknesses are evident and if not corrected, repayment may be at a risk
Excessive Risk	Relationships where impairment of one or more credit components has occurred and loss of principle or interest is likely
Unacceptable Risk	Relationships where a loss of principle or interest is assured

Quarterly Review of Classifications

The review:

- Ensures the review encompasses a review of debt service
- Makes it difficult to overlook this tangible measurement tool

Credit Deterioration

If significant credit deterioration occurs between quarterly reviews:

- Adjust classification
- Begin remedial action

Creditworthiness declines can occur at anytime. For example:

- Regulatory changes
- Natural disasters

Prompt update of classification is critical to controlling potential losses. It:

- Draws attention to a worsening situation
- Prompts corrective action

Remedial Action for High Risk or Worse

Place on a watchlist or other similar internal list of potential problems and begin corrective actions when companies are classified “high risk.”

- The credit officer set specific strategies and action plans to fix the weakness.
- Senior management is advised through circulation of the watchlist.

Transfer to the problem loan department, if it exists, companies downgraded to “excessive risk” or “unacceptable risk.”

Changing Relationship Objectives

Relationship Management				Recovery Management	
Classification Ratings					
1	2	3	4	5	6
Changing Objectives					
<ul style="list-style-type: none"> • Increase business volume • Build strong personal relationships • Provide excellent service • Maximize value 				<ul style="list-style-type: none"> • Improve collateral • Control cash flows • Obtain repayment • Control management • Minimize losses 	

Transfer Problem Loan

- Problem identified, bank's objectives change from relationship management to recovery management.
- Recovery management requires specialized skills.
- Transferring loan ensures early action is taken.

Problem Loan Transfer Checklist

Items to Be Completed Before Transfer	Date	Transferring Manager's Initials
1) Change to problem loan status		
2) Customers files updated		
3) Recovery officer debriefed		
4) Customer introduced		
5) All Documentation Transferred		

Administering the Problem Loan

The bank should have standard operating procedures for notifying branches of a customer downgrade to Problem Borrower Status.

- Advice should go out to all branches through most appropriate means.
- Pre-approval of how to apply payments should be forwarded to relevant branches by the Officer handling the problem loan.
- All operating transactions, including application of overpayments, should be referred to the Recovery Officer.

Discussion

- What types of problem loans have you seen?
- Do they tend to have recurring characteristics? (such as similar industries, types of management, etc.)
- What have you found to be helpful for getting the greatest recovery on a problem loan?
- Participants who have a fully implemented classification system, please give examples of how it works.
- Participants who do not have a fully implemented classifications system, please give examples of the judgment criteria used.
- Give examples of how the transfer of the loan files is implemented.

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Unit 3:
Recovery Analysis

Purpose

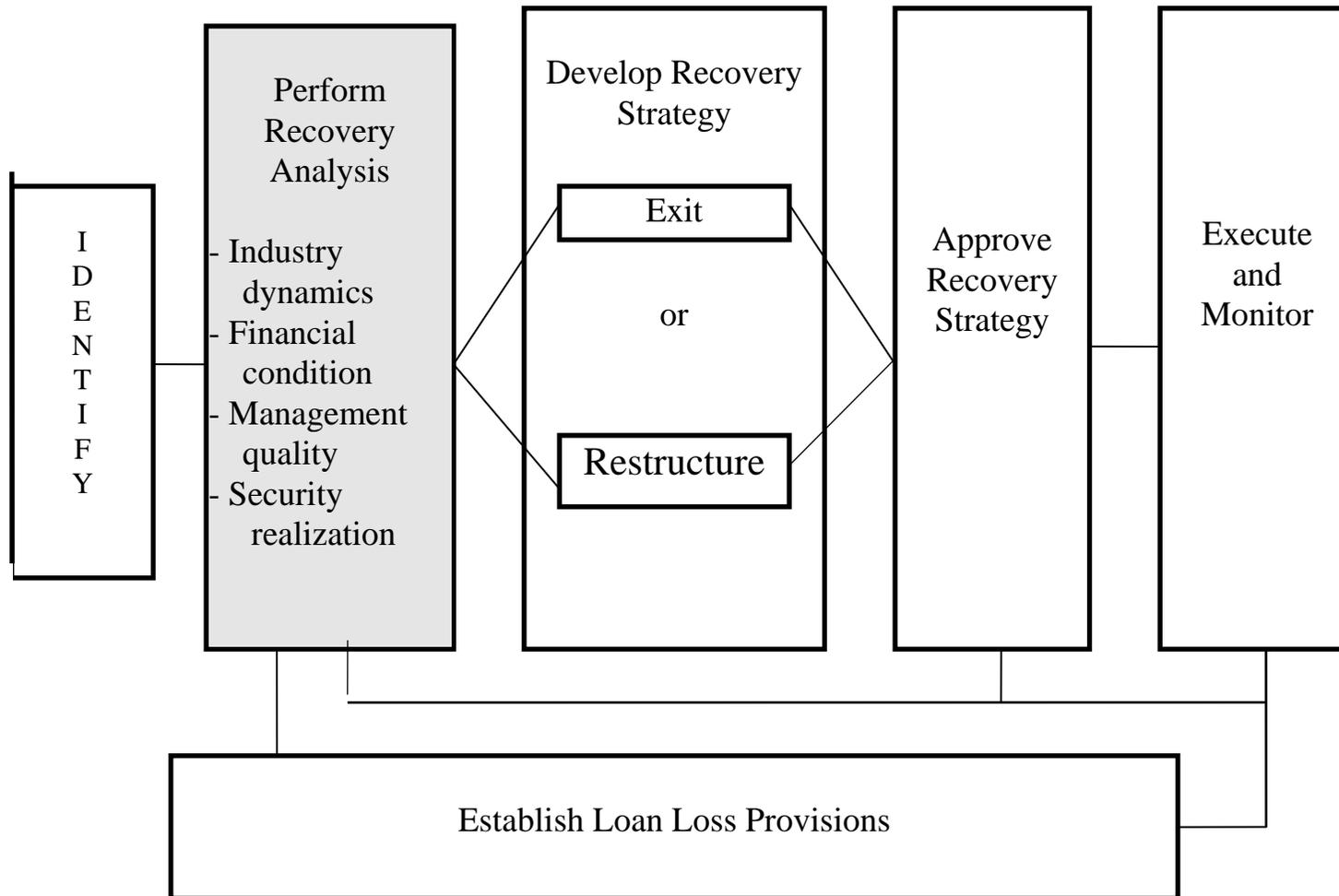
- Develop an in-depth evaluation of bank's position.
- Develop an effective recovery strategy.

Objectives

At the end of this unit, you will be able to:

1. Analyze the creditworthiness of the problem relationship.
2. Formulate an appropriate strategy for managing the problem relationship.

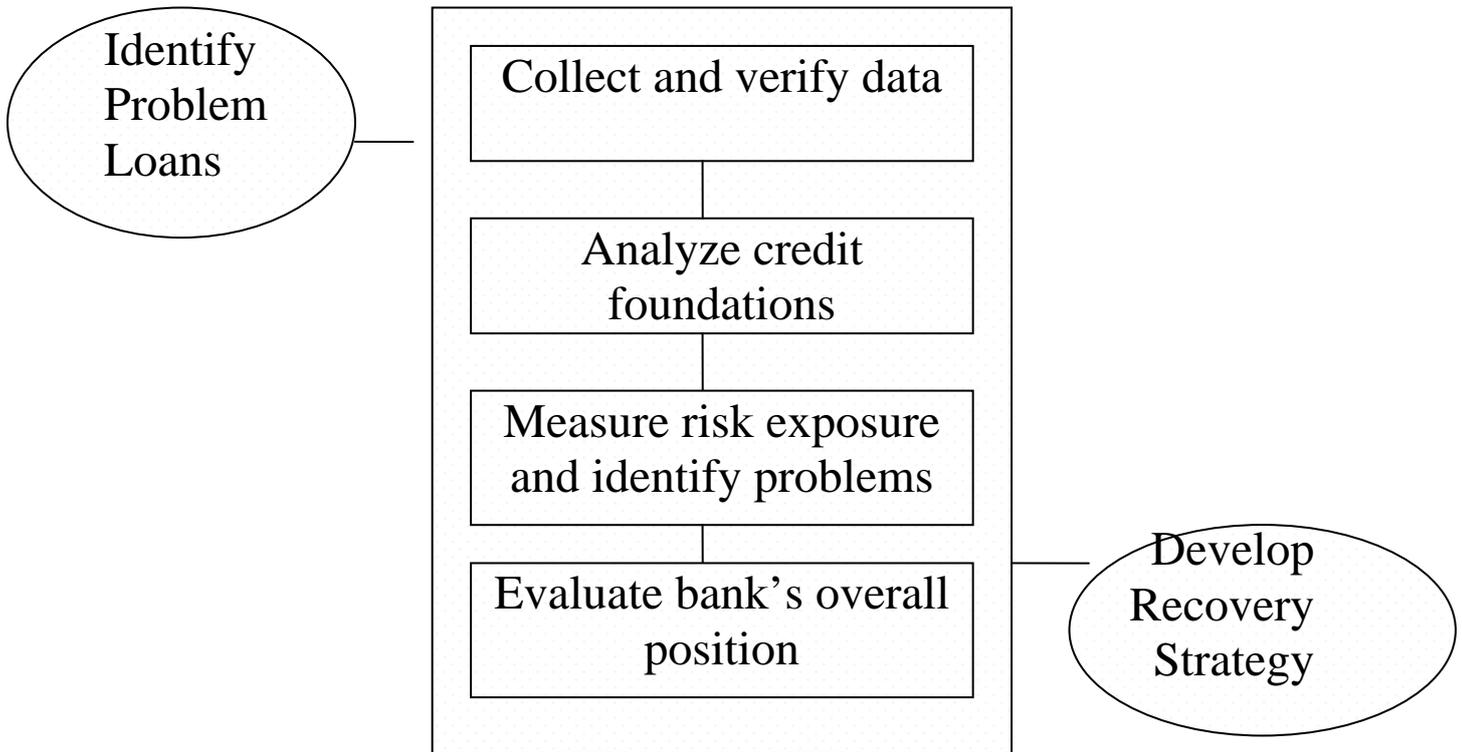
Problem Loan Recovery Process



Recovery Analysis

- Focuses on diagnosing specific credit problems
- Seeks to develop an in depth evaluation of back's position
- Provides strong foundation to develop effective recovery strategies

Recovery Analysis Process



Verify Data

- Verify data onsite
- Verify externally
- Data requests will over time, begin to change the practices of the company

Roles of Bank Staff

- Recovery Inspector
- Technical Support -- for example, engineers or real estate appraisers
- Administrative Assistants

Credit Foundations

Industry Dynamics

- Determines the nature of the industry environment and the borrower's position within the industry

Financial Condition

- Determines borrower's capacity to repay through cash flow, collateral liquidation, or other sources

Credit Foundations, continued

Management Quality

- Determines the integrity, competence, and reputation of borrower's management team

Security Realization

- Determines control of security and likely net present value

Data Collection

FOUNDATION	DATA REQUIRED	DATA SOURCES
Industry Dynamics	<ul style="list-style-type: none"> • Industry profile -- 3 years <ul style="list-style-type: none"> - Size, growth - Concentrations - Cyclicity/seasonality - Explanation of trends • Industry outlook • Profiles of key competitors (top two) • Regulatory profile -- current, recent changes, expected changes • Borrower's strategy • Key alliances: <ul style="list-style-type: none"> - With government - With private sector - With other influential players 	<ul style="list-style-type: none"> • Internal <ul style="list-style-type: none"> - Files - Research department - Other managers familiar with industry • Third parties <ul style="list-style-type: none"> - Ministries - Multilateral agencies -- USAID, World Bank, etc. - Other government organizations - Trade associations - Other banks - Other companies in industries • External -- customer calls • Library research and subscriptions
Financial Condition	<ul style="list-style-type: none"> • Company financials -- 3 years <ul style="list-style-type: none"> - Profit & loss statements, balance sheets - Supplementary statements -- reconciliation of net worth, fixed assets - Audited where possible • Creditor facilities <ul style="list-style-type: none"> - Banks } amounts and condition of - Suppliers } facilities 	<ul style="list-style-type: none"> • Internal <ul style="list-style-type: none"> - Files - Other managers familiar with borrower • Borrower <ul style="list-style-type: none"> - In person calls - Site visits

Data Collection, continued

FOUNDATION	DATA REQUIRED	DATA SOURCES
Financial Condition... Continued	<ul style="list-style-type: none"> • Additional company financial data: <ul style="list-style-type: none"> - Related company financials - Inter-group accounts - Accounts receivable aging - Explanation of key accounts -- investments, other assets/liabilities, etc. • Financial projections • Credit check -- at least 2 banks 	<ul style="list-style-type: none"> • Third parties <ul style="list-style-type: none"> - Credit Bureau - Creditors -- banks and suppliers
Management Quality	<ul style="list-style-type: none"> • Background on all senior managers, including board members <ul style="list-style-type: none"> - Education, experience - Skills • Management's track record <ul style="list-style-type: none"> - Performance - Information provided, meetings attended, other obligations - Standing with other creditors • Alliances <ul style="list-style-type: none"> - With government - With private sector - With other influential players 	<ul style="list-style-type: none"> • Internal <ul style="list-style-type: none"> - File reviews - Other managers • Borrower <ul style="list-style-type: none"> - In person calls - Manager interviews - Site visits • Third party <ul style="list-style-type: none"> - Government officials familiar with managers - Private sector individuals - Credit bureau - Creditors -- banks and suppliers

Data Collection, continued

FOUNDATION	DATA REQUIRED	DATA SOURCES
Security Realization	<ul style="list-style-type: none"> • Security documentation <ul style="list-style-type: none"> - Titles and deeds - Insurance policies - Guarantees - Other documents • Legal opinion on executability • Physical verification • Assessed value • Data base of similar cases <ul style="list-style-type: none"> - Liquidation value of security vs. assessed value - Time to realize value • Confirmation of bank's seniority 	<ul style="list-style-type: none"> • Internal <ul style="list-style-type: none"> - Files, vaults - Interview with managers - Interview with lawyers - Case histories • Borrower <ul style="list-style-type: none"> - Site visits - Calls • Third party <ul style="list-style-type: none"> - Assessors - Other lawyers - Creditors (concerning double pledging)

Analysis Required in Central and Eastern European Markets

- All credit problems must be identified and assessed
- A full evaluation of the bank's position is required

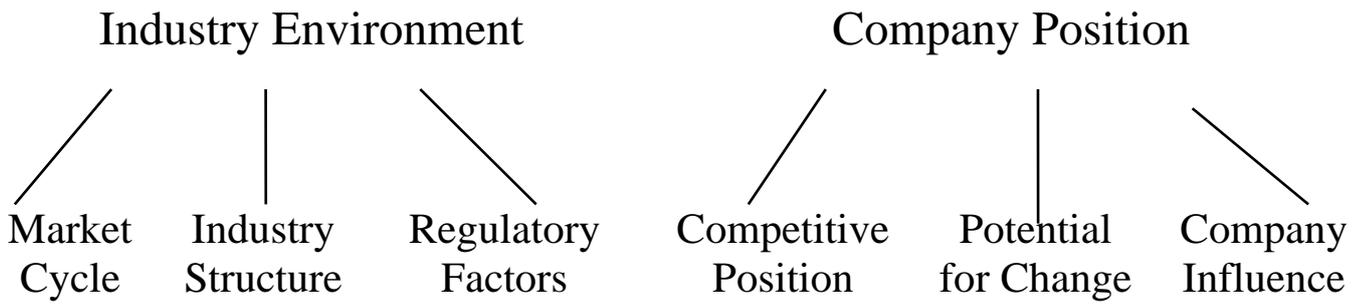
Interactive Nature of the Foundations

- Problems in the Industry Dynamics may weaken financial condition and security realization e.g., when banking industries have experienced deregulation and competition increases causing reduced loan margins and ultimately bank profitability
- Deteriorating financial condition may affect security realization e.g., when a textile plant was experiencing a weak cash flow, it undertook inventory and receivable liquidation to improve cash flow. This undermined the bank's security position.

Interactive Nature of the Foundations, continued

- Poor management quality will have adverse impact on the other three foundations e.g., if management lacks proper skills and makes poor business decisions, then ultimately
 - Sales decline and profitability suffers
 - The company's position within the industry declines
 - Value of assets erodes, undermining the bank's security position

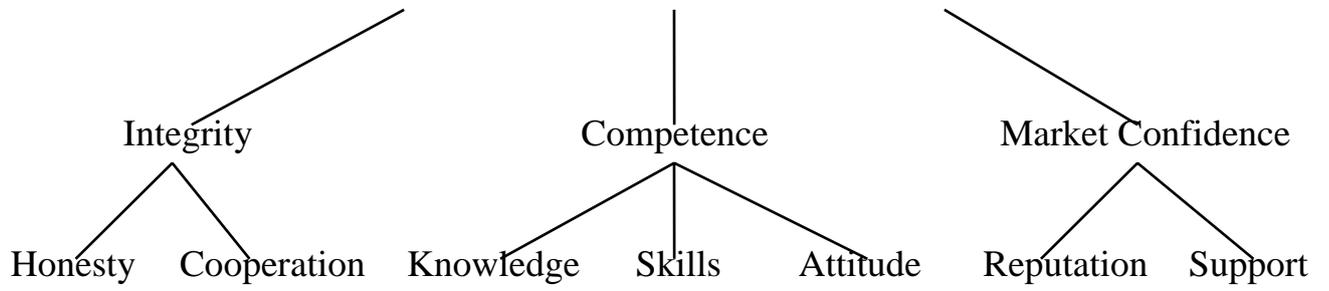
Industry Dynamics



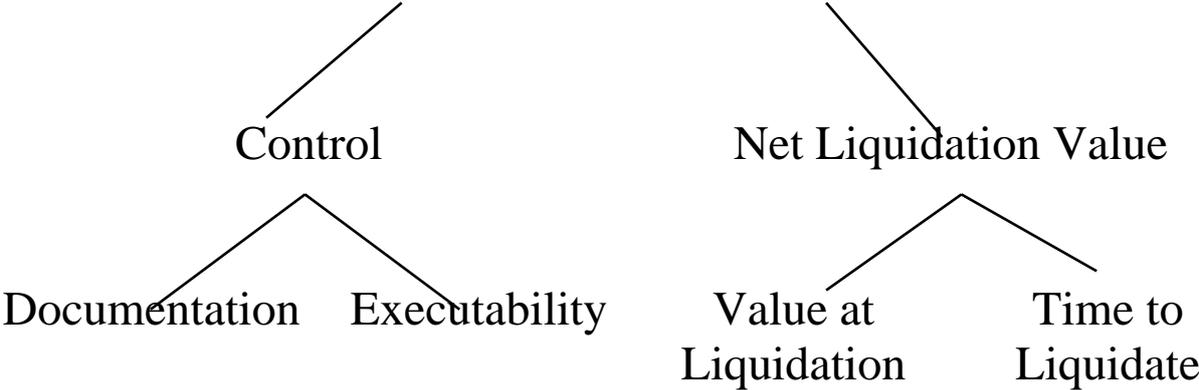
Financial Condition



Management Quality



Security Realization



First Foundation: Industry Dynamics

RISK AREA	RATIONALE
Industry Environment	 <ul style="list-style-type: none">• Structural problems in an industry can affect overall risk of lending to an industry -- e.g., low returns, high costs, highly competitive, etc.• Environmental changes can have negative impact on lending -- e.g. trade imbalances, FX deregulation, reduction in trade barriers, etc.
Company Position Within the Industry	 <ul style="list-style-type: none">• Competitive dynamics can put some companies at a critical advantage or disadvantage• Weakness in key areas required to succeed could affect overall risk of lending

First Foundation: Industry Dynamics, continued

INDUSTRY ENVIRONMENT

COMPONENTS	ANALYSIS	PROBLEM AREAS (EXAMPLE)
Industry Cycle	<ul style="list-style-type: none"> • Determine market size and growth during past 5 years • Assess why market is growing/declining • Determine how the market is segmented in terms of: <ul style="list-style-type: none"> - Customers - Geography • Determine shares of leading competitors and degree of concentration • Assess other relevant factors <ul style="list-style-type: none"> - Cyclicity - Seasonality 	<ul style="list-style-type: none"> • Shrinking market • Volatile market • Dominant competitors forcing out smaller ones • Key competitors have differentiated product with strong loyalties
Industry Structure	<ul style="list-style-type: none"> • Evaluate industry characteristics and determine key features of each: <ul style="list-style-type: none"> - Nature of products - Barriers to entry/exit - Supplier power - Customers - Substitute products • Determine structural implications of industry characteristics (see facing exhibit) <ul style="list-style-type: none"> - Distribution channels - Level of fixed costs and overcapacity 	<ul style="list-style-type: none"> • Commodity like product leading to low profit margins • Low barriers to entry resulting in overcapacity • Supply interruption • Overreliance on few, weak suppliers • Buyer concentration and power <ul style="list-style-type: none"> - Large concentrations - Standard and undifferentiated product - Low switching costs - Buyer • Certain competitors have locked up key distribution channels

First Foundation: Industry Dynamics, continued

INDUSTRY ATTRACTIVENESS

COMPONENTS	ANALYSIS	PROBLEM AREAS (EXAMPLE)
Regulatory Factors	<ul style="list-style-type: none">• Review regulations which govern industry• Review recent changes and determine likelihood and nature of future changes• Evaluate impact of recent and potential future changes on industry	<ul style="list-style-type: none">• Elimination of price controls leading to competition• New players allowed to enter market• Additional risk exposure from deregulation of FX markets• Price controls on key inputs lifted

First Foundation: Industry Dynamics, continued

COMPANY POSITION

COMPONENTS	ANALYSIS	PROBLEM AREAS (EXAMPLE)
Competitive Position	<ul style="list-style-type: none"> • Identify key success factors -- what a company must do well to succeed -- based on industry attractiveness analysis • Review competitors' performance against key success factors • Review company's performance against key Competitors • Rank company's position 	<ul style="list-style-type: none"> • Company disadvantaged in critical areas and not able to compete
Potential for Change	<ul style="list-style-type: none"> • Review company's strategy • Assess in terms of: <ul style="list-style-type: none"> - Degree to which it addresses weaknesses/ Strengths - Degree to which it addresses challenges/ Opportunities - Management's ability to execute 	<ul style="list-style-type: none"> • No strategy exists to address weaknesses/ improve position • Strategy is not practical or achievable
Company Influence	<ul style="list-style-type: none"> • Review political affiliations • Review private affiliations • Assess implications for bank's position and company's performance 	<ul style="list-style-type: none"> • Company poorly positioned to lobby for critical issues • Company aligned with unpopular or weak players

Example

INDUSTRY DYNAMICS SUMMARY

Page 1 of 2

Borrower: Vyroba Carpet		Recovery Inspector:
Industry: Carpet manufacturing and export		Date Completed: March 20, 1999
Summary Overall Assessment:	Level of Risk	MR
Credit Problems:		
<ul style="list-style-type: none"> • Signs of oversupply and reputation for quality declining in key markets • Company fairly well positioned, but faces quality control problem which could weaken future position 		
Summary Analysis of Key Risk Areas:		
	<u>Level of Risk</u>	<u>Comments/Credit Problems</u>
1. Industry Environment:		
a. Market cycle	MR	<ul style="list-style-type: none"> • Market growth leveling • Demand concentrated in German • Declining profit margins • Low barriers to entry, increasing competition • Favorable change in FX regulations
b. Industry structure	MR	
c. Regulatory factors	LR	
Overall:	MR	

Example

INDUSTRY DYNAMICS SUMMARY

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2. <u>Company Position Within Industry:</u>	<u>Overall Risk:</u>	MR
a. <u>Key success Factors:</u>	<u>Level of Risk</u>	<u>Comments/Credit Problems</u>
Access to low cost wool	LR	<ul style="list-style-type: none"> • Diversified sources of wool supply
Low cost labor	MR	<ul style="list-style-type: none"> • Labor demanding higher wages
Differentiated product	HR	<ul style="list-style-type: none"> • Follows market trend
Quality reputation	HR	<ul style="list-style-type: none"> • Inconsistent quality of product
Diverse range of buyers	LR	<ul style="list-style-type: none"> • Several large German, French buyers
b. <u>Summary of Company's Approach:</u>	<u>Level of risk:</u>	<u>Comments/Credit Problems</u>
<ul style="list-style-type: none"> • Will hire new designer to develop differentiated product line • However, no plan to address quality control line 	MR	<ul style="list-style-type: none"> • Strategy does not fully address weaknesses
c. <u>Company Influence:</u>	<u>Level of risk:</u>	<u>Comments/Credit Problems</u>
<ul style="list-style-type: none"> • Well connected with key politicians and private sector players 	LR	None

Sample Classifications Definitions

Low Risk	Relationships that represent minimal risk, all credit components are strong now in the foreseeable future
Acceptable Risk	Relationships that represent satisfactory risk with no material weakness apparent
Moderate Risk	Relationships where one or more credit components are weak; although no immediate loss is evident, close monitoring is required
High Risk	Relationships where material weaknesses are evident and if not corrected, repayment may be at a risk
Excessive Risk	Relationships where impairment of one or more credit components has occurred and loss of principle or interest is likely
Unacceptable Risk	Relationships where a loss of principle or interest is assured

Vyroba Carpet Industry Dynamics Ratings

RATING	INDUSTRY DYNAMICS RISK AREAS	COMPANY POSITION
Excessive and Unacceptable Risk	<ul style="list-style-type: none"> • Shrinking market; highly cyclical and concentrated • Severe structural problems • Unfavorable regulatory environment 	<ul style="list-style-type: none"> • Company severely disadvantaged • No strategy • Alliances impair market position
High Risk	<ul style="list-style-type: none"> • No market growth, cyclical and concentrated • Unattractive structure • Worsening regulatory environment 	<ul style="list-style-type: none"> • Weak against all key success factors • Poor strategy • Alliances weaken position
Moderate Risk	<ul style="list-style-type: none"> • Slowing growth, signs of increasing cyclical • Emerging structural concerns • Neutral regulatory environment 	<ul style="list-style-type: none"> • Slightly disadvantaged against key success factors • Strategy only partially addresses weaknesses • Neutral alliances
Low and Acceptable Risk	<ul style="list-style-type: none"> • Growing, attractive market • Attractive structure • Favorable regulatory environment; no expected Change 	<ul style="list-style-type: none"> • Well positioned • Practical, achievable strategy • Favorable alliances

Second Foundation: Financial Condition

RISK AREA	RATIONALE
Profitability	 <ul style="list-style-type: none">• Indicates operating success, growth potential and competitive position• Often misrepresented and therefore must be scrutinized very closely
Liquidity	 <ul style="list-style-type: none">• Determines ability to meet obligations -- operating expenses, debt service, supplies credit, etc.
Leverage	 <ul style="list-style-type: none">• Determines degree of financial risk and ability to absorb business risk• Is a sign of owners' commitment to the business

Second Foundation: Financial Condition, continued

RISK AREA	STRENGTH MEASURES	ANALYSIS	PROBLEM AREAS (EXAMPLE)
Profitability	<ul style="list-style-type: none"> • Financial ratios: <ul style="list-style-type: none"> - Return on assets - Return on sales - Return on equity - Operating profit/sales - Admin cost/sales - Etc. • Profit and loss statement analysis • Inventory quality • Fixed asset quality 	<ul style="list-style-type: none"> • Complete financial spreads • Verify profitability information and determine credibility • Perform trend analysis • Compare figures with other companies in industry • Perform site visits to assess inventory and fixed asset quality 	<ul style="list-style-type: none"> • Declining revenue • Increasing costs <ul style="list-style-type: none"> - Payroll - Financing - Cost of goods • Insufficient profits to support growth • Insufficient scale -- excess fixed costs • Insufficient inventory to meet demand • Outdated production • Insufficient skilled labor
Liquidity	<ul style="list-style-type: none"> • Financial ratios: <ul style="list-style-type: none"> - Current - Quick - Working capital/assets - Inventory turnover - Accounts receivable days on hand 	<ul style="list-style-type: none"> • Same as above • Evaluate integrity of creditor support • Evaluate current asset quality and aging of receivables 	<ul style="list-style-type: none"> • Poor quality current assets • Illiquid investments • Non-productive fixed assets • Withdrawal of creditor support

Second Foundation: Financial Condition, continued

RISK AREA	STRENGTH MEASURES	ANALYSIS	PROBLEM AREAS (EXAMPLE)
Liquidity...cont'd	<ul style="list-style-type: none"> • Financial ratios...cont'd <ul style="list-style-type: none"> - Interest/Operating profit - Etc. • Cash flow: <ul style="list-style-type: none"> - Debt service - Sources funds analysis - Uses funds analysis • Lines of credit <ul style="list-style-type: none"> - Bankers - Suppliers 	<ul style="list-style-type: none"> • Assess shareholders' support <ul style="list-style-type: none"> - Willingness to guarantee - Willingness to inject additional capital • Review cost structure • Develop debt service profile • Review investment budget • Review intra-group accounts <ul style="list-style-type: none"> - Consolidating statements - Receivables and payables to related companies - Prices to related companies - Dividend payments - Owners' salaries/payment 	<ul style="list-style-type: none"> • Withdrawal of shareholder support • High cost borrowings/bunching of payments • High payroll/material costs • Large investment costs • Diversion of funds to associated companies/transfer pricing
Leverage	<ul style="list-style-type: none"> • Financial ratios <ul style="list-style-type: none"> - Debt/Equity - Debt structure • Rate sensitivity 	<ul style="list-style-type: none"> • Same as under Performance • Assess quality of reserve accounts • Reconcile net worth and verify • Evaluate capital structure • Assess creditor/shareholder support • Perform rate sensitivity analysis under varying rate scenarios 	<ul style="list-style-type: none"> • Withdrawal of support • High cost borrowings/bunching of payments • Overvalued equity • Inappropriate capital structure • Oversensitivity to interest rate swings

Example

FINANCIAL CONDITION SUMMARY

Page 1 of 2

Borrower : Vyroba	Recovery Inspector:
Date Most Recent Financial Statements : February, 1998	Date Completed : March 20, 1999
Period Covered : 1998 - 1999	Number Years Information Analyzed: 4
Audited : <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	Reliability of Financials: <input type="checkbox"/> Very Reliable <input checked="" type="checkbox"/> Reliable <input type="checkbox"/> Unreliable
Overall Financial Condition	Level of Risk: <input checked="" type="checkbox"/> ER
Credit Problems: <ul style="list-style-type: none">• Increased leverage to finance recent plant expansion has adversely impacted performance, leverage, and liquidity• Large inventory build up from inability to sell increased product further impaired all aspects of financial condition	
Summary Analysis of Key Risk Areas:	
1. Profitability Level Of Risk: <input checked="" type="checkbox"/> ER	% Net Income/Sales: (4%)
Credit Problems/Comments: <ul style="list-style-type: none">• Profitability reporting is fairly reliable• Rapidly rising administrative costs -- from 5% of sales to 10% over past 3 years• Increasing interest expense associated with financing of plant expansion (4% - 8% of sales)• High depreciation costs (2% - 4% of sales)	

Example

FINANCIAL CONDITION SUMMARY

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2. <u>Liquidity</u> Level of Risk:	ER	Net Operating Income/Debt Service:	0.75
Credit Problems/Comments:		Current Assets/Current Liabilities:	0.8

- Increased debt service associated with debt financing of new plant
- Large inventory build up associated with inability to sell product from increased production
- Short term financing used to finance fixed assets

3. <u>Leverage</u> Level of Risk:	ER	Debt/Equity:	4
Credit Problems:		Debt/Tangible Net Worth:	5

- Large loan recently taken on to finance plant expansion
- Owners were unwilling to inject more capital
- Losses have exceeded capital

Vyroba Carpet Financial Condition Ratings

RATING	PERFORMANCE	LIQUIDITY	LEVERAGE
Excessive Risk & Unacceptable Risk	<ul style="list-style-type: none"> • Negative ratios, declining trend • Increasing cost ratio, declining revenue ratios 	<ul style="list-style-type: none"> • Debt/Service below 1 • Current ratios below 0.75 • Declining trend • Well below industry average 	<ul style="list-style-type: none"> • Debt/Tangible Net Worth >5 • Owners not willing to inject equity • Large amount of short-term debt supporting fixed assets
High Risk	<ul style="list-style-type: none"> • Profit ratios probably negative • Flat trend • Cost ratios high, but not Increasing 	<ul style="list-style-type: none"> • Debt/Service well below 1 • Current ratios below 0.75 - 1 • Flat trend • Below industry 	<ul style="list-style-type: none"> • Debt/Tangible Net Worth 3 - 5 • Owners not willing to inject equity • Short term debt financing fixed assets
Medium Risk	<ul style="list-style-type: none"> • Profit ratios positive, but Declining • Costs increasing • Below industry average 	<ul style="list-style-type: none"> • Debt/Service above 1.5 • Current ratios above 1 • Declining trend • Below industry average 	<ul style="list-style-type: none"> • Debt/Tangible Net Worth 2-3 • Owners willing to provide limited support • Start term debt financing fixed working capital
Low Risk & Acceptable Risk	<ul style="list-style-type: none"> • Positive ratios, well above industry average • Flat increasing trend 	<ul style="list-style-type: none"> • Debt/Service above 2 • Strong current ratio • Above industry average 	<ul style="list-style-type: none"> • Debt/Tangible Net Worth below 2 • Strong owner support • Appropriate capital structure

Third Foundation: Management Quality

RISK AREA	RATIONALE
Integrity →	<ul style="list-style-type: none">• Forms the whole basis for a sound banking relationship• Lack of integrity leads to:<ul style="list-style-type: none">- Inability to assess risk- Inability to negotiate and reach sound agreements- Lack of confidence in application of bank funds
Competence →	<ul style="list-style-type: none">• Incompetent management has little chance of addressing and resolving credit problems to restore creditworthiness• Poor management judgment leads to credit problems and failures
Market Confidence →	<ul style="list-style-type: none">• Reputation will influence management/bank power balance and could make it difficult to approach and negotiate with management• If management's reputation is strong, the company may be better off to survive a crisis

Third Foundation: Management Quality, continued

RISK AREA	STRENGTH MEASURES	ANALYSIS	PROBLEM AREAS (EXAMPLE)
Integrity	<ul style="list-style-type: none"> • Honesty <ul style="list-style-type: none"> - Quality/Reliability of information - Meeting commitments - Character and track record • Cooperativeness <ul style="list-style-type: none"> - Consistency and quality of communication with bank - Supportiveness 	<ul style="list-style-type: none"> • Review credit files <ul style="list-style-type: none"> - Note missing information/documentation - Frequency/nature of communication • Interview branch/regional managers familiar with customer • Interview management <ul style="list-style-type: none"> - Test openness - Ask for references - Develop impressions • Interview government/private sector individuals familiar with management • Interview auditors • Compare information with other creditors 	<ul style="list-style-type: none"> • Quality/reliability of information <ul style="list-style-type: none"> - Failure to disclose - Misrepresentation - Inconsistent information - Changing auditors - Refusing audits • Meeting commitments <ul style="list-style-type: none"> - Failure to meet with bank - Failure to meet contractual obligations - Failure to provide documentation - Double pledging security • Character <ul style="list-style-type: none"> - Obsessive tax avoidance - Involved in questionable activities - Poor reputation • Communication <ul style="list-style-type: none"> - Postponing meetings • Supportiveness <ul style="list-style-type: none"> - Will not provide information - Will not pledge security

Third Foundation: Management Quality, continued

RISK AREA	STRENGTH MEASURES	ANALYSIS	PROBLEM AREAS (EXAMPLE)
Competence	<ul style="list-style-type: none"> • Ability <ul style="list-style-type: none"> - Experience - Operating skills - Financial skills - Administrative skills - Management structure - Management depth • Competence <ul style="list-style-type: none"> - Decision-making track record - Risk profile 	<ul style="list-style-type: none"> • Interview branch/region manager • Interview management • Obtain key managers' curriculums and determine: <ul style="list-style-type: none"> - Education - Experience - Related skills • Review performance <ul style="list-style-type: none"> - Profits, growth, direction of trends - Compared with other companies • Review organization chart <ul style="list-style-type: none"> - Determine span of control - Ensure all functions present • Interview private sector/ government individuals familiar with management • Review risk profile - investments, projects, debt/leverage • Compare impressions with other creditors 	<ul style="list-style-type: none"> • Experience <ul style="list-style-type: none"> - Lack of relevant experience - Inability to manage • Skills <ul style="list-style-type: none"> - Insufficient skills to manage key areas • Management structure <ul style="list-style-type: none"> - Biased board - Lack of key functions - Lack of depth • Decision-making <ul style="list-style-type: none"> - Autocratic style - Lack of MIS/analysis - Unwilling to make difficult decisions (cost cutting, etc.) - Risk profile - High risk investments
Market Confidence	<ul style="list-style-type: none"> • Reputation • Support 	<ul style="list-style-type: none"> • Interviews • Time in business • Group memberships 	<ul style="list-style-type: none"> • Management disliked by competitors who may spread rumors • Out of favor politically • Poor reputation

Example

MANAGEMENT QUALITY SUMMARY

Page 1 of 2

Borrower: Vyroba
General Manager: R.J. Tapa
Principal Shareholder: P.R. Pande

Recovery Inspector
Date Prepared: March 20, 1999
% Company Owned: 80%

Overall Management Quality
Credit Problems/Comments:

Level of Risk:

MR

- Missing financial controller
- Competence questioned by recent decision to expand and increase leverage
- Otherwise, high integrity and favorable alliances

Summary Key Risk Areas:

1. Integrity Level of Risk: **LR** (Honesty, Cooperativeness)

Credit Problems/Comments:

- Management quick to provide any information requested
- Consistently meet obligations
- Very cooperative and open

Example

**2. Competence Level of Risk:
Credit Problems/Comments:**

**(Ability -- Experience, Skills, Depth;
Competence -- Decision-making, MIS Profile)**

**3. Market Confidence
Level of Risk: Credit Problems/
Comments**

(Affiliations, Lobbying Power, Power Balance vs. Bank)

Vyroba Carpet Management Quality Ratings

RATING	INTEGRITY	COMPETENCE	MARKET CONFIDENCE
Excessive & Unacceptable Risk	<ul style="list-style-type: none"> • Never meets commitments • Poor quality, unreliable Information • Refuses to support relationship 	<ul style="list-style-type: none"> • No relevant experience/skills • No vision • No depth • Inappropriate organization structure • Aggressive risk taker 	<ul style="list-style-type: none"> • Allied against current Administration • Poor reputation causing loss of Credit
High Risk	<ul style="list-style-type: none"> • Rarely meets commitments • Information is of low quality, low Reliability • Weak relationship support 	<ul style="list-style-type: none"> • Limited experience/skills • Limited vision • Limited depth • Poor structure • Risk taker 	<ul style="list-style-type: none"> • Recent problems diminishing Reputation
Medium Risk	<ul style="list-style-type: none"> • Generally meets commitments • Reasonable quality information, generally reliable • Supports relationship 	<ul style="list-style-type: none"> • Moderate experience/skills • Moderate depth • Some vision • Adequate structure • Risk neutral 	<ul style="list-style-type: none"> • Neutral reputation
Low & Acceptable Risk	<ul style="list-style-type: none"> • Always meets commitments • Quality, reliable information • Strong relationship support 	<ul style="list-style-type: none"> • Experience/skilled • Visionary • Deep management team • Good structure • Risk adverse 	<ul style="list-style-type: none"> • Strong reputation

Fourth Foundation: Security Realization

SECURITY REALIZATION		
RISK AREA		RATIONALE
Control	→	<ul style="list-style-type: none">• Without proper documentation the bank has no claim on security• Without ability to execute claim, security cannot be realized
Net Liquidation Value	→	<ul style="list-style-type: none">• Low liquidation values may not cover outstanding debts• High liquidation costs will reduce net amount received• Security quality may deteriorate over time• Money has time value

Fourth Foundation: Security Realization, continued

RISK AREA	STRENGTH MEASURES	ANALYSIS	PROBLEM AREAS (EXAMPLE)
Control	<ul style="list-style-type: none"> • Perfection <ul style="list-style-type: none"> - Legal rights - Documentation adequacy - Double pledged security - Fraud - Insurance policy • Executability <ul style="list-style-type: none"> - Ability to obtain favorable Judgment - Ability to take possession - Length of legal process 	<ul style="list-style-type: none"> • Verify documentation <ul style="list-style-type: none"> - Security perfection - Documentation completeness - Documentation integrity - Insurance policy and documentation • Assess customer's lobbying power with legal authorities, local potential buyers • Conduct site visit(s) to verify security existence • Review recent trends in legal execution • Assess length of time to complete legal action 	<ul style="list-style-type: none"> • Legal rights <ul style="list-style-type: none"> - Land title not pledged - Bank has second priority or is Subordinated • Documentation adequacy <ul style="list-style-type: none"> - Lacking notary - Missing signatures - Incomplete documentation - Lacking stamp duty - Outdated, past due • Fraud <ul style="list-style-type: none"> - Criminal proceedings • Insurance does not cover Exposure • Ability to obtain favorable Judgment <ul style="list-style-type: none"> - Customer has strong lobbying Power - Judge sympathetic towards Customer • Ability to take possession <ul style="list-style-type: none"> - Missing security - Difficulty in evicting squatters - Security transferred - Security immobile • Length of legal process <ul style="list-style-type: none"> - Documentation difficulties - Lobbying conflicts - Slowness of due process

Fourth Foundation: Security Realization, continued

RISK AREA	STRENGTH MEASURES	ANALYSIS	PROBLEM AREAS (EXAMPLE)
<p>Net Liquidation Value</p>	<ul style="list-style-type: none"> • Liquidation value <ul style="list-style-type: none"> - Quality - Quantity • Time of sale <ul style="list-style-type: none"> - Market price dynamics - Opportunity cost - Technology replacement - Long legal process 	<ul style="list-style-type: none"> • Use assessor to value security <ul style="list-style-type: none"> - Quality & quantity - Market demand • Review recent cases <ul style="list-style-type: none"> - Assessed value vs. sale value - Change in sale value - Time to sell • Review economic conditions • Determine overall likely length of sale <ul style="list-style-type: none"> - Auction process - Auction success/failure - Sale on secondary market • Select appropriate discount rate • Determine Net Liquidation Value 	<ul style="list-style-type: none"> • Security is of poor quality or Perishable • Quantity not sufficient to cover Exposure • Market demand <ul style="list-style-type: none"> - No market for goods - Security highly specialized - Value too large -- few can afford - Borrower has influence over potential buyers - Collusion against bank • Market price dynamics <ul style="list-style-type: none"> - Volatility - Inflation - Rapid depreciation • Opportunity cost – value increases/decreases over time • Technology -- security becomes Obsolete • Legal process <ul style="list-style-type: none"> - Erodes security value - Market could change during Process

Example

SECURITY REALIZATION SUMMARY- CONTROL

<p>Borrower: Vyroba Carpets</p> <p>Assessor: Name: A. Murray FDM: Engineer Experts</p>	<p>Recovery Inspector: Date Prepared: March 28, 1999 Date of Assessment: January 10, 1999</p>
<div style="display: flex; justify-content: space-between;"> <div style="width: 60%;"> <p>Security Realization Level of Risk</p> <p>Security Coverage:</p> <ul style="list-style-type: none"> • Control: Security perfected and adequate executability • Net Liquidation Value (000's) : 524 Cedi (Primary + Secondary Security) • Exposure (000's): 2,500 Cedi • % NPV/Exposure: 20% (Security Cover) </div> <div style="width: 35%; text-align: center;"> <div style="border: 1px solid black; padding: 2px; display: inline-block; margin-bottom: 10px;">ER</div> <p><u>Credit Problems:</u></p> <ul style="list-style-type: none"> • Reduced liquidation value of machinery due to uncertainty regarding carpet market • Real estate market uncertainty and long lead time of sale reduces security value </div> </div>	
<div style="display: flex; justify-content: space-between;"> <div style="width: 60%;"> <p>Summary Key Areas: <u>Credit Problems/Comments:</u></p> <p>1. Control Level of Risk: LR</p> <p>a. Perfection:</p> <ul style="list-style-type: none"> • All documentation perfected and in place • Bank has senior claim on all security <p>b. Executability:</p> <ul style="list-style-type: none"> • Customer not likely to lobby in case of liquidation • Security can be easily transferred • Potential for court delays in obtaining secondary security, but not expected to be excessive </div> <div style="width: 35%; text-align: center;"> <p>Date Last Site Visit : February 10,1998 Date Security Doc. Checklist: December 20,1997</p> </div> </div>	

Example

SECURITY REALIZATION SUMMARY - NET LIQUIDATION VALUE

2. Net Liquidation Value	Level of Risk	ER	(Cedi 000)	
				<u>Total</u>
a. Category of Security	Building & Marketing	Land	-	N.A.
b. Assessed liquidation value	1,500	600	-	2,100
c. Liquidation Value Discount	35%	32%	-	N.A.
d. Time of Sale (Number of years)	2	3	-	N.A.
e. Discount Rate (%) (1 year fixed deposit rate+4%)	15%	15%	-	15%
f. Discount factor (1/(1 + e) d)	76%	65%	-	N.A.
g. Net Liquidation Value (b x c x f)	399	125	-	524
h. Exposure (principle+interest)	-	-	-	2,500
i. % NPV/Exposure -- Security Cover (g/h)	-	-	-	20%

Vyroba Carpet Security Realization Ratings

RATING	CONTROL	NET LIQUIDATION VALUE
Excessive Risk & Unacceptable Risk	<ul style="list-style-type: none"> • Security not perfected • Executability severely impaired 	<ul style="list-style-type: none"> • Security cover below 50%
High Risk	<ul style="list-style-type: none"> • Perfection is weak • Executability complex 	<ul style="list-style-type: none"> • Security cover 50% - 75%
Medium Risk	<ul style="list-style-type: none"> • Perfection adequate • Potential executability issues 	<ul style="list-style-type: none"> • Security cover 75% - 100%
Low Risk & Acceptable Risk	<ul style="list-style-type: none"> • Strong perfection • No executability complications 	<ul style="list-style-type: none"> • Security cover above 100%

Step 4: Evaluate Overall Position

- Assess the combined impact of the risks
- Review for level of risk and credit problems in each foundation
- Look for common problems across foundations
- Look for how problems interact
- Reviewing combined impact provides a full understanding of overall risk
- The analysis will also facilitate strategy development
 - Can creditworthiness be restored?
 - Is exit or structure appropriate?
 - Supports development of an action plan?

Example

SUMMARY RISK ASSESSMENT

Borrower: Vyroba Carpet

Recovery Inspector:

Date Prepared: March 20, 1998

Summary Overall Position:

Level Risk

ER

List most salient credit problems and indicate symptoms in each pillar and trace cause/effect relationships

Credit Foundation:	Industry Dynamics	Financial Condition	Management Quality	Security Realization
Level Risk:	MR	ER	MR	ER
Credit Problems: <ul style="list-style-type: none"> Aggressive expansion financed by debt 	-	<ul style="list-style-type: none"> Decreased leverage Reduce profitability Lower liquidity 	<ul style="list-style-type: none"> Brings into operation competence Shows evidence of high risk taker 	<ul style="list-style-type: none"> New plant may be difficult to liquidate
<ul style="list-style-type: none"> Growing overcapacity and concerns regarding product quality 	<ul style="list-style-type: none"> Over-competitiveness Overcapacity 	<ul style="list-style-type: none"> Decreased inventory Increased leverage-need to finance working capital 	-	<ul style="list-style-type: none"> Lower value or security

Discussion

1. What are two objectives of recovery analysis?
2. What are the four creditworthiness foundations to be analyzed?
3. In CEE, what may be the primary focus areas?
4. What are the three risk areas of financial condition that should be analyzed?
5. Once each credit foundation has been analyzed, what is the key next step?

Summary

- After problem loan is identified, you:
 - Conduct a recovery analysis
 - Formulate a management strategy

- The four credit foundations are:
 - Industry Dynamics
 - Financial Condition
 - Management Quality
 - Security Realization

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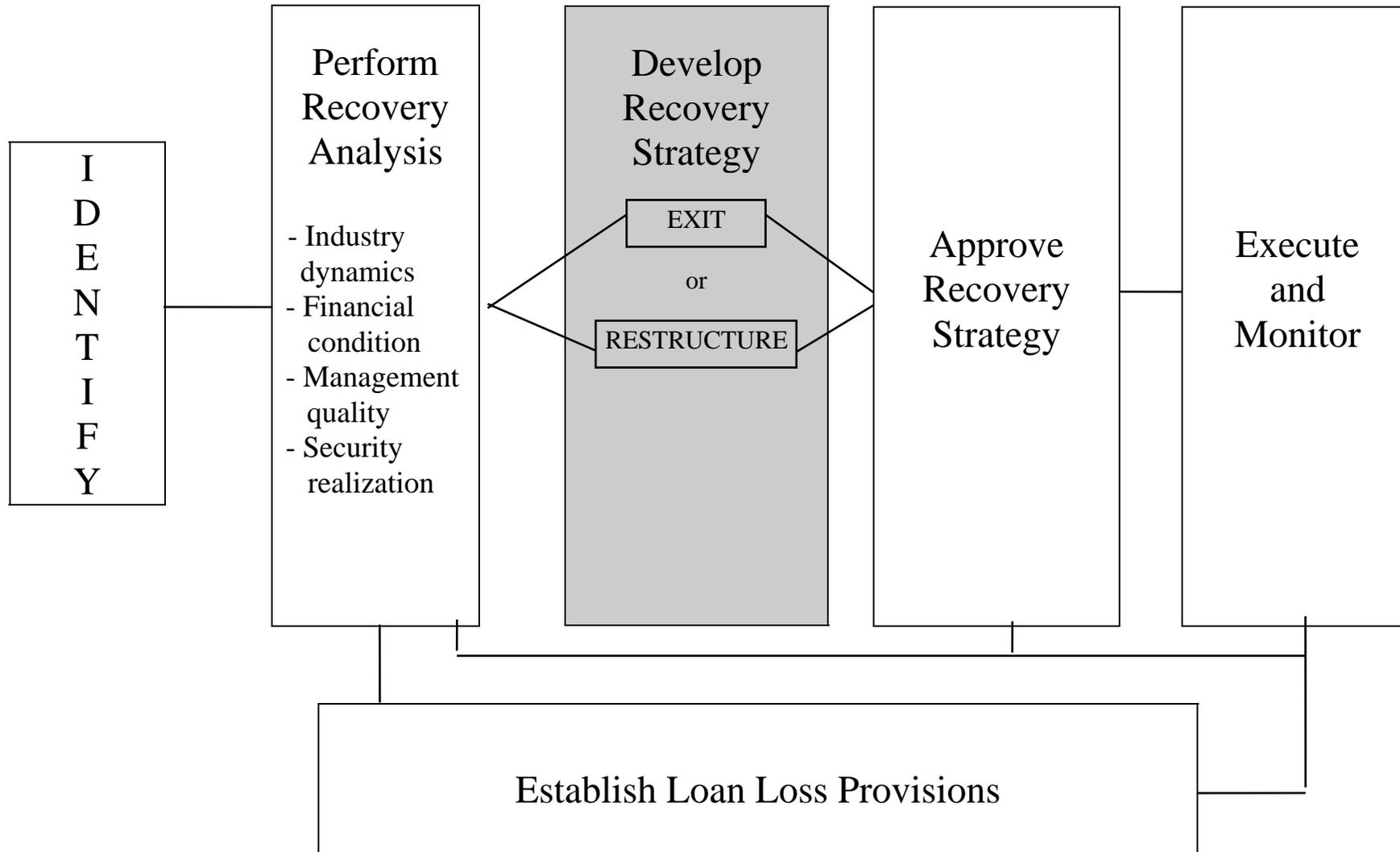
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Unit 4 :
Strategy Development

Problem Loan Recovery Process



Objectives

At the end of this unit, you will be able to:

1. Define the process required to make appropriate strategy decisions.
2. Conduct the analysis needed to make appropriate strategy decisions.
3. Formulate action plans to carry out the decisions.

Strategy Development

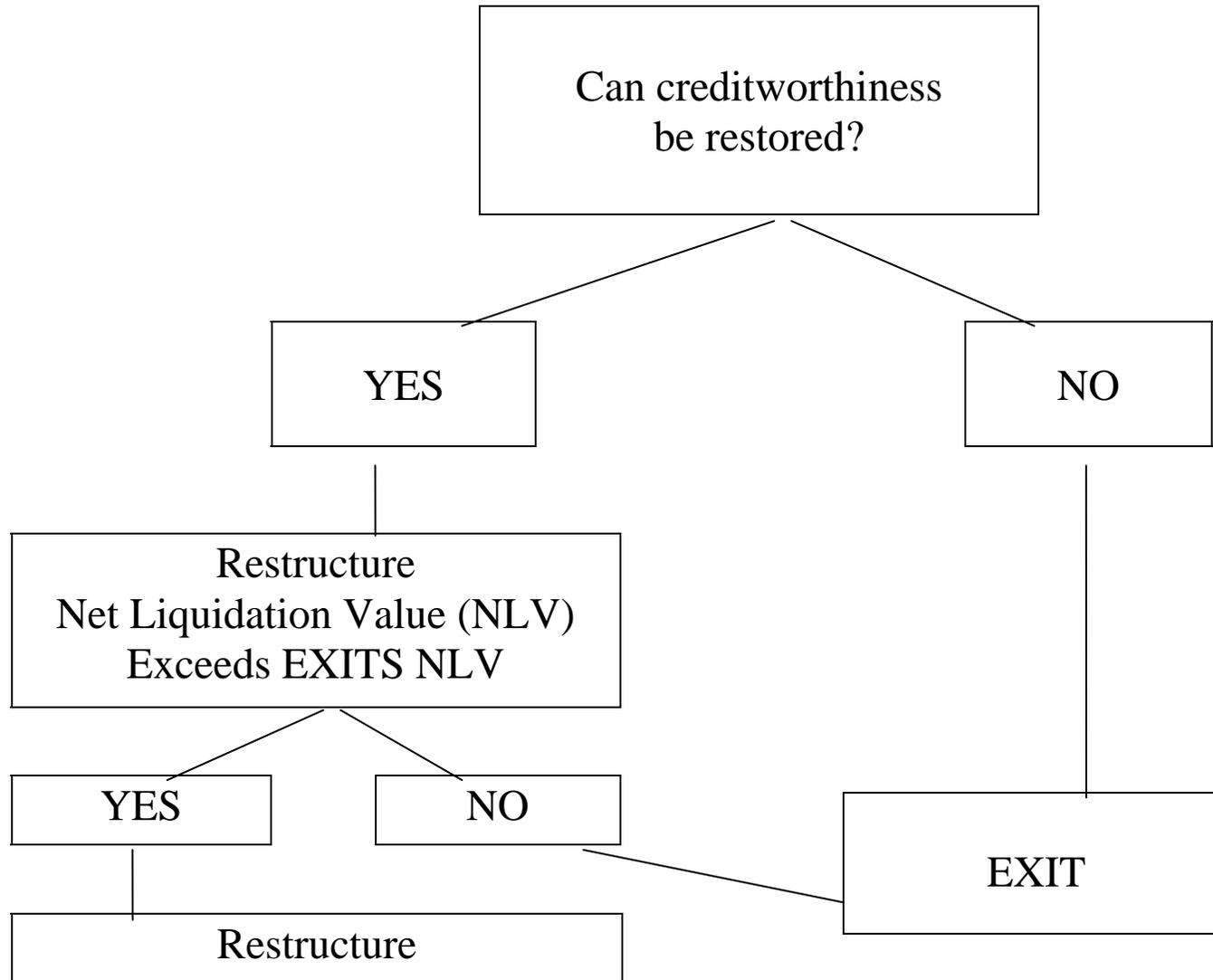
Strategy development has the primary objective of maximizing recoveries through development of appropriate action plans.

- The recovery analysis determined the type and severity of the problem.
- The strategy development determined the appropriate response.

Major Decisions of the Strategy Development Process

- Can the overall creditworthiness be restored?
- Should we exit or restructure?
- What is the best approach within the selected exit or restructure course?

Recovery Strategy Framework



Can the overall creditworthiness be restored?

- If creditworthiness cannot be restored, an exit strategy is the required course.
- If creditworthiness can be restored, restructuring may be the required course.

Process For Determining Restoration of Creditworthiness

<i>Foundation</i>	<i>Risk Area</i>	<i>Problem</i>	<i>Method of Fixing</i>	<i>Likelihood of a Fix</i>
Identify Weak Foundations	Identify Problem Risk Areas Associated with the Weak Foundation	Understand the Individual Elements and Sources	Determine Method of Fixing	Estimate Likelihood
Industry Dynamics	Industry Environment	Market Structure	Obtain Government Protection of Industry	Unlikely Fix <ul style="list-style-type: none"> - Industry in decline cycle Product substitution has occurred - Government more market oriented

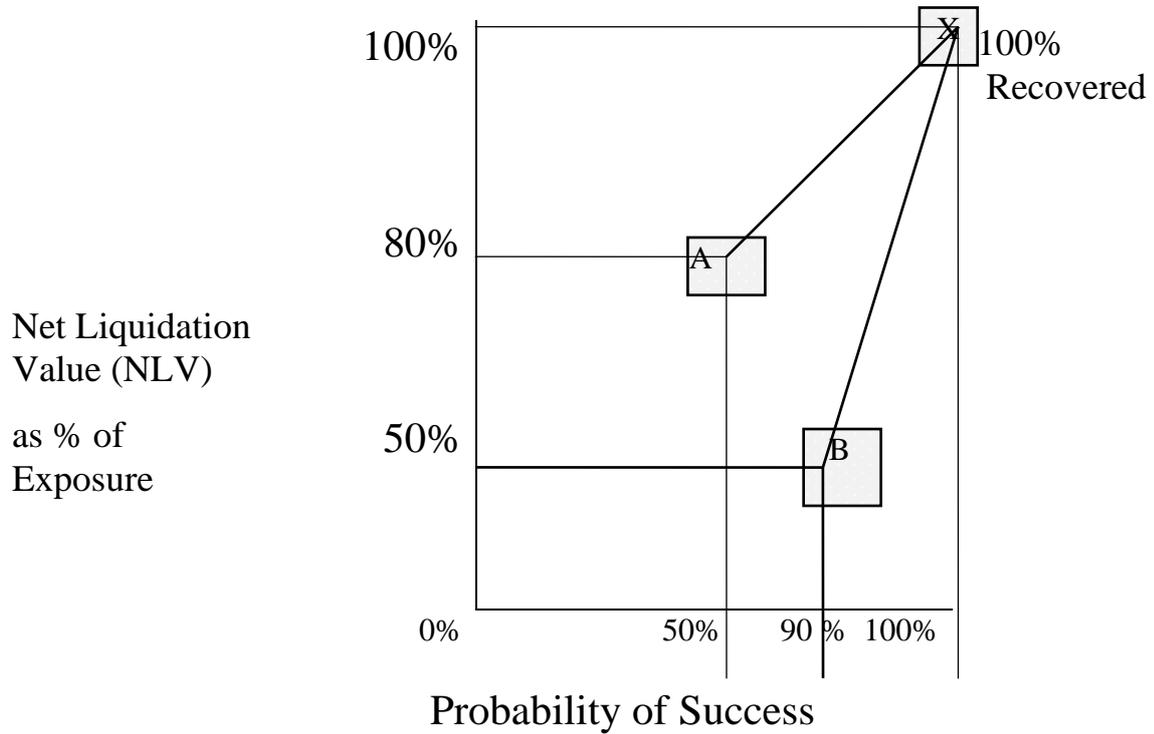
Some Generic Fix Strategies

INDUSTRY DYNAMICS	FINANCIAL CONDITIONS	MANAGEMENT QUALITY	SECURITY REALIZATION
<ul style="list-style-type: none"> • Diversify business • Improve competitive position <ul style="list-style-type: none"> - Strengthen key weaknesses e.g., replace management - Revise strategy • Seek government assistance <ul style="list-style-type: none"> - Lower or raise tariffs - Reduce regulatory constraints 	<ul style="list-style-type: none"> • Restructure operations <ul style="list-style-type: none"> - Expenditure cuts <ul style="list-style-type: none"> - Reduce investments - Change pricing • Liquidate assets <ul style="list-style-type: none"> - Sell inventory - Collect A/Rs - Sell assets • Owners infuse new capital • Restructure debt service by lengthening debt service 	<ul style="list-style-type: none"> • Restructure Management <ul style="list-style-type: none"> - Replace <ul style="list-style-type: none"> - Impose outside consultants - Reorganize • Restructure credit agreements <ul style="list-style-type: none"> - Require outside audits <ul style="list-style-type: none"> - Impose performance/operating covenants • Solicit government support to break alliances 	<ul style="list-style-type: none"> • Restructure security <ul style="list-style-type: none"> - Perfect security - Obtain additional security • Liquidate security <ul style="list-style-type: none"> - Sell security with highest Net Liquidation Value - Settle respective debt • Take equity ownership (last resort)

Common Examples of When to Use Exit Strategy in Central and East European Markets

- Many relationships show severely weakened security realization with little chance for improvement.
- Financial condition is severely weakened.
- Management integrity is often considered poor.

Maximizing Recovery



(NLV - Costs) X Probability of success)

Exit Option: 80% X 50% = 40%
 Restructure Option: 50% X 90% = 45%

Appropriate Strategy - Restructure

Major Collection Costs

- Management time
- Administrative costs
- Legal costs
- Monitoring costs
- Adverse publicity

**SECURITY REALIZATION SUMMARY -
NET LIQUIDATION VALUE**

EXAMPLE

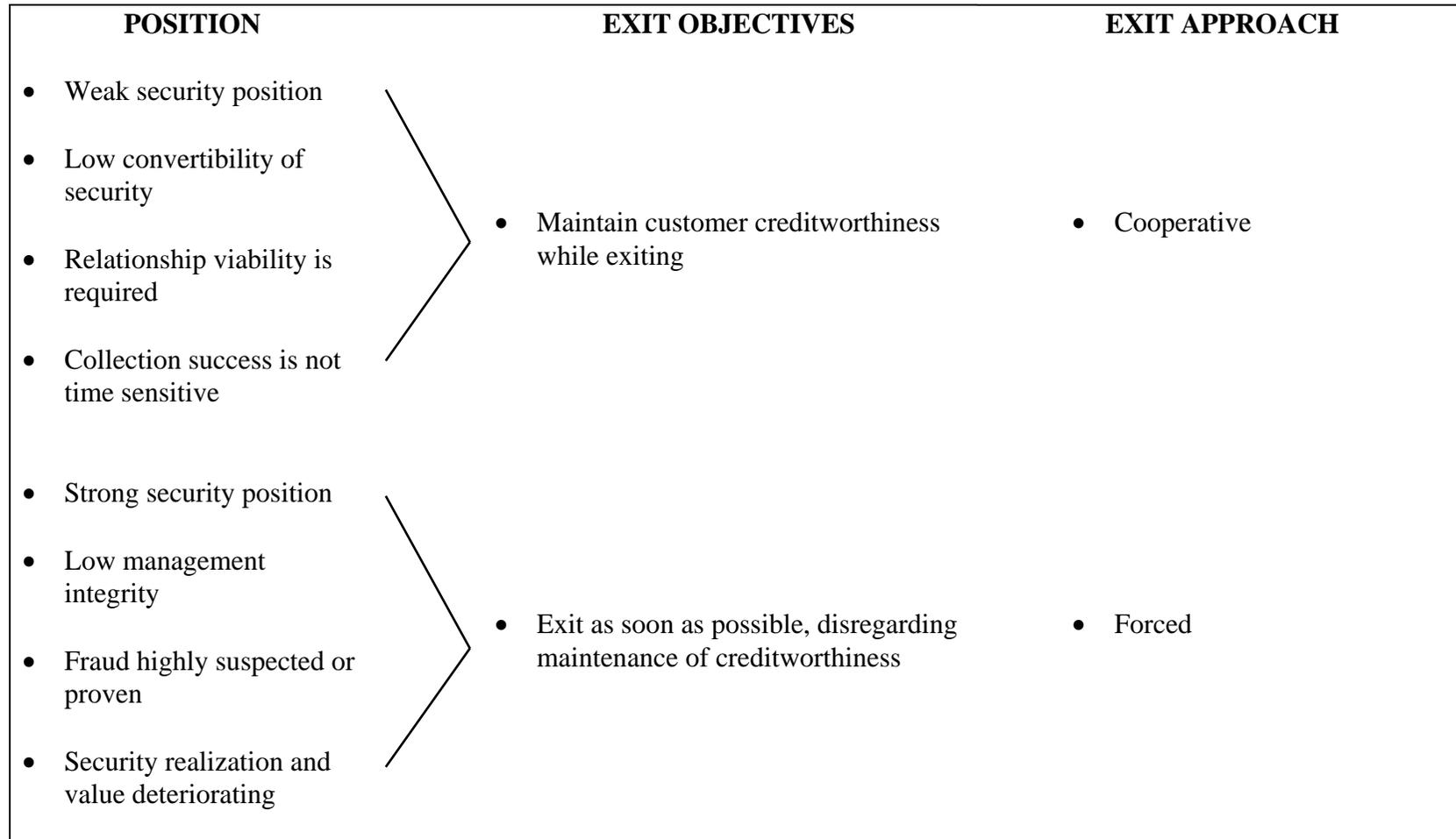
2. Net Liquidation Value	Level of Risk	ER	(Cedi 000)		<u>Total</u>
a. Assessed liquidation value	3,000	800	-	-	3,800
b. Liquidation value discount	50%	60%	-	-	N.A.
c. Time of sale (Number of years)	2	3	-	-	N.A.
d. Discount rate (%)	20%	20%	-	-	20%
e. Net liquidation value (a x b x (c+d))	960	240	-	-	1,200
f. Exposure (principle+interest)	-	-	-	-	2,500
g. % NPV/Exposure -- security cover (f/g)	-	-	-	-	48%

Exit Strategy

Cooperative or Forced Approach

- Exposures can be reduced in a cooperative fashion.
- Forced exits can be chosen and often involved legal action.

Exit Approaches



Choose the Approach that Maximizes Net Liquidation Value

- The cost of postponing liquidation is factored in to reflect the time value of money.
- Different strategies have different probabilities of success.

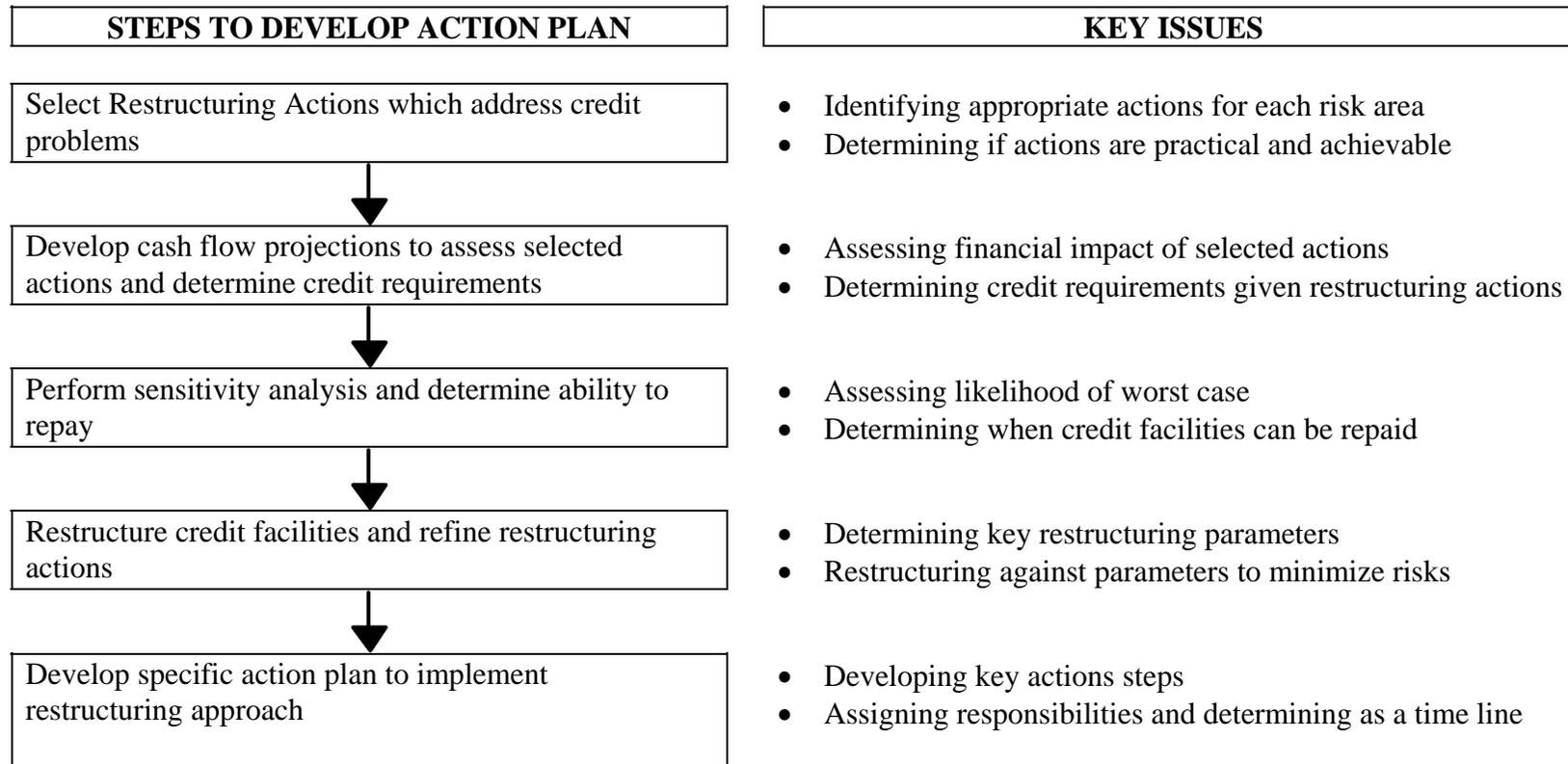
Government Support

- Many problem loans are for state-owned enterprises.
- Request for government assistance is reserved for large, very problematic situations.

Examples of Credit Problems Requiring Government Assistance

Credit Foundation	Credit Problems
Industry Dynamics	<ul style="list-style-type: none">● Government regulations are hindering collections
Management Quality	<ul style="list-style-type: none">● Commitment of fraud● Strong alliances used to avoid/postpone obligations
Security Realization	<ul style="list-style-type: none">● Problems with evicting current owner● Unnecessary delays in court proceeding● Manager fled country

Restructuring Approaches



Industry Dynamics

RISK AREAS	POSSIBLE RESTRUCTURING ACTIONS	RATIONALE/COMMENTS
Industry Environment	<ul style="list-style-type: none"> • Diversify into other industries • Obtain government support <ul style="list-style-type: none"> - Lower barriers - Erect barriers • Exit unattractive industries • Start new business 	<ul style="list-style-type: none"> • Reconciling industry weaknesses is difficult to achieve
Company Position	<ul style="list-style-type: none"> • Strengthen specific weakness • Find attractive niche • Create alliances to improve overall clout • Exit if prospects are poor 	<ul style="list-style-type: none"> • A <u>realistic</u> view of a company's position and ability to improve its position is required to make proper decisions
Regulatory Factors	<ul style="list-style-type: none"> • Obtain government relief from onerous regulations • Lobby government to create new regulations to better protect the company 	<ul style="list-style-type: none"> • Government support unlikely if counter to overall policy

Financial Condition

RISK AREAS	POSSIBLE RESTRUCTURING ACTIONS	RATIONALE/COMMENTS
Liquidity	<ul style="list-style-type: none"> • Obtain additional credit support • Restructure debt service (interest and principal) • Liquidate assets • Secure additional investment of equity 	<ul style="list-style-type: none"> • Possibility to coordinate action with other creditors • Government support in encouraging owners to increase capital could be helpful
Leverage	<ul style="list-style-type: none"> • Liquidate assets • Obtain additional capital • Forgive debt 	<ul style="list-style-type: none"> • All three actions should yield a reduction in debt
Profitability	<ul style="list-style-type: none"> • Restructure operations <ul style="list-style-type: none"> - Require expenditure cuts - Increase efficiencies - Sell or close unprofitable businesses - Improve pricing • Help company secure new markets 	<ul style="list-style-type: none"> • Often requires a long time • Could use knowledge of other customers' business to act as match maker

Management Quality

RISK AREAS	POSSIBLE RESTRUCTURING ACTIONS	RATIONALE/COMMENTS
<p>Integrity</p> <p>Competence</p> <p>Market Confidence</p>	<ul style="list-style-type: none"> • Replace management • Impose operating guidelines/restrictions • Impose outside consultants • Replace management • Replace management 	<ul style="list-style-type: none"> • Integrity faults can rarely be fixed, replacement is the only viable option • Operating guidelines or specific restrictions can help discipline and focus management • Outside consultants can fill the void in competence • Reputation difficult to repair once ruined

Security Realization

RISK AREAS	POSSIBLE RESTRUCTURING ACTIONS	RATIONALE/COMMENTS
<ul style="list-style-type: none"> • Perfection • Executability • Time Required to Sell • Liquidation Value 	<ul style="list-style-type: none"> • Perfect security • Obtain government support with expediting the legal process • Obtain additional security • Improve value of security <ul style="list-style-type: none"> - Upgrade facilities - Complete project 	<ul style="list-style-type: none"> • Without perfection, security holds little or no value • Most executability and time problems are due to slow or “affected” legal system • Provides additional support for first way out • Increases options

Cash Flow Projections Consider the Impact of Restructuring Actions on:

- Major cash inflows
- Major cash outflows

Sensitivity Analysis

- Develop worst/best case assumptions for each of the restructuring actions and other key risk elements.
- Adjust projections to reflect new assumptions under each scenario.
- Extend projections until debt can be repaid.
- Determine probability worst case will occur.
- After cash flow sensitivity analysis, reassess the recovery strategy and revise as needed.

Recommended Structural Parameters

Amount	→	Credit requirements, cash flow analysis and projections
Repayment Schedule	→	Repayment ability based on projections
Security	→	Security realization analysis, strength of first way out
Pricing	→	Expected customer profitability (analysis not yet introduced)
Monitoring Requirements/Covenants	→	Assessment of each credit foundation, identification of key risks
Documentation	→	Key risks, security realization, management quality analysis

Action Plans include:

- A negotiating approach
- Detailed action steps
- Specific milestones

Discussion Questions

- What are the major causes behind the exit or restructure decision?
- What would you consider when examining if creditworthiness can be restored?
- What are some of the “fixes” available for restoring creditworthiness?
- When is it best to exit?
- What role does the sensitivity analysis play?
- What should be included in the action plan?

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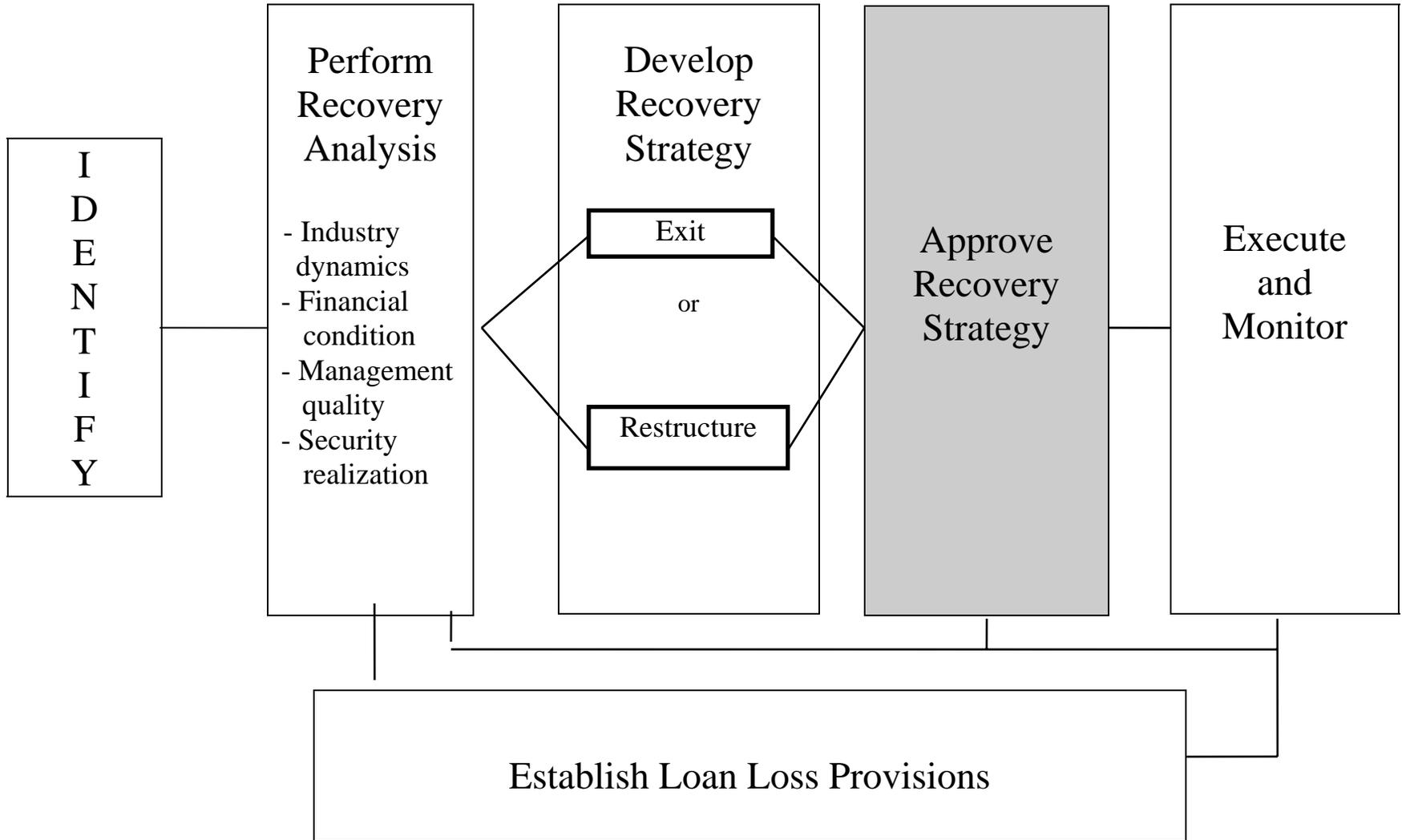
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Unit 5:
Strategy Approval

Problem Loan Recovery Process



Objective

At the end of this unit, participants will be able to:

1. Prepare a recovery approval package that facilitates communication, approval, monitoring, and controlling the recovery strategy.

Purpose of Unit

The objective of preparing a recovery credit approval package (CAP) is to facilitate communicating, approving, monitoring, and controlling the recovery strategy. It:

- Provides guidelines to Recovery Inspectors for:
 - What data to obtain
 - What analysis to complete for developing strategies
- Establishes standard format for documenting and communicating recovery analysis and strategies

Credit Analysis Package (CAP)

- Facilitates approval process. It:
 - Makes available
 - ◆ data
 - ◆ analysis
 - ◆ recommendations
 - Highlights key issues
 - Summarizes and presents critical information in a succinct and accessible format
- Addresses and highlights key risks to focus the monitoring process
- Documents the credit process to facilitate credit auditing

Key Components of Credit Analysis Package (CAP)

Recovery CAP is:

- Composed of eleven key components
- Assembled and prepared by the Recovery Officer with assistance from technical and administrative support

Sample CAP Components

RECOVERY CAP COMPONENT	DESCRIPTION
------------------------	-------------

MAIN DOCUMENTS

1. Credit Approval Summary Sheet	<ul style="list-style-type: none"> • Summarizes key approval information and contains approval signature • Comprised of four key sections: <ul style="list-style-type: none"> - Overview/approval - Facilities - Security - Procedural information
2. Recovery Proposal Memo	<ul style="list-style-type: none"> • Provides explanation of approval request • Summarizes analysis, risk assessment • Recommends credit action

SUPPORTING DOCUMENTS

3. Basic Information Report ⁽¹⁾	<ul style="list-style-type: none"> • Summarizes key borrower information relevant to credit analysis - Ownership/ Shareholdings, Management/Directors, History, Creditors, Operations, Affiliated companies
4. Financial Spread Sheets ⁽¹⁾	<ul style="list-style-type: none"> • Presents financial information in standard format to facilitate analysis - Profit/Loss, Balance Sheet, Ratios, Cash Flow
5. Projection Forms ^(1/2)	<ul style="list-style-type: none"> • Presents financial projections to determine and structure credit facilities

Sample CAP Components

RECOVERY CAP COMPONENT

DESCRIPTION

SUPPORTING DOCUMENTS

6. Risk Assessment Form ¹⁾ A. Overall Evaluation B. Industry Dynamics C. Financial Condition D. Management Quality E. Security Realization	<ul style="list-style-type: none"> • Provides a summary of analysis of each credit foundation, measurement of risk and identification of credit problems
7. Recovery Strategy Development Form	<ul style="list-style-type: none"> • Presents analysis and rationale for selected strategy • Provides detailed action plan
8. Request For Government Assistance ³⁾	<ul style="list-style-type: none"> • Provides rationale for government assistance and proposes role
9. Site Visit Report	<ul style="list-style-type: none"> • Summarizes objectives, results and follow-up requirements for site visits
10. Investigation Summary Form ¹⁾	<ul style="list-style-type: none"> • Summarizes findings from key investigations conducted to gather and verify data <ul style="list-style-type: none"> - Banks - Buyers - Suppliers
11. Security Documentation Check Off List	<ul style="list-style-type: none"> • Summarizes results to security documentation review

1. Not required if company is bankrupt and in liquidation
2. Not required if exit strategy is being pursued
3. Only required if government assistance is requested

Note: Recommended forms for each document are presented in Appendix

Sample Recommended Recovery Proposal Memo Contents

TOPIC	DESCRIPTION
I. Purpose of the Credit Analysis Memo	<ul style="list-style-type: none"> • Summary of the purpose: <ul style="list-style-type: none"> - Re-approve strategy - Recommend initial/new strategy - Restructuring facilities - Increase facilities • Brief description of relationship and facilities
II. Overview of Credit Quality (one section on each credit foundation)	<ul style="list-style-type: none"> • Summary of analysis in each foundation with specific discussion of the level of risk and credit problems • Taken from Risk Assessment Form (RAF)
III. Credit Requirements and Two Sources of Repayment	<ul style="list-style-type: none"> • Description of credit requirements based on projections • Specific discussion of two payment sources -- company cash flow and security • Not required when exit strategy pursued
IV. Key Risks	<ul style="list-style-type: none"> • Overall evaluation of the bank's position highlighting specific risks and possible fixes

Sample Recommended Recovery Memo Contents, continued

TOPIC	DESCRIPTION
V. Recommendations/Recovery Strategy	<ul style="list-style-type: none">• Recommended strategy including:<ul style="list-style-type: none">- Exit vs. restructure- Approach- Action plan • For restructuring strategy, includes six structural elements<ul style="list-style-type: none">- Amount- Repayment schedule- Collateral- Pricing- Monitoring/Requirements/Covenants- Documentation

Credit Inspector Responsibilities

- Expediently prepare initial preparation of the CAP to minimize potential losses.

- Review in detail the relationship, at least once per year
 - Review each credit foundation to assess changes in risks and credit problems

 - Reassess strategy to determine if desired outcome is achieved and if it is still appropriate

 - Revise strategy to reflect analysis

- Conduct a partial CAP for bankrupt customers in liquidation

Credit Inspector Responsibilities, Continued

- Establish the next CAP review date -- 12 months from current review

- Require preparation of the CAP and obtain approval by review date. Failure results in suspension of credit facilities. Failure:
 - Represents exposure to risks not properly assessed

 - Forces prompt responses to complete CAP

Discussion

1. Why is a recovery approval package developed?
2. What are the main documents of the approval package?
3. List several key supporting documents.
4. How much time should be given to prepare a recovery CAP from identification of the problem?
5. Is a customer is bankrupt and in liquidation is a recovery CAP required?

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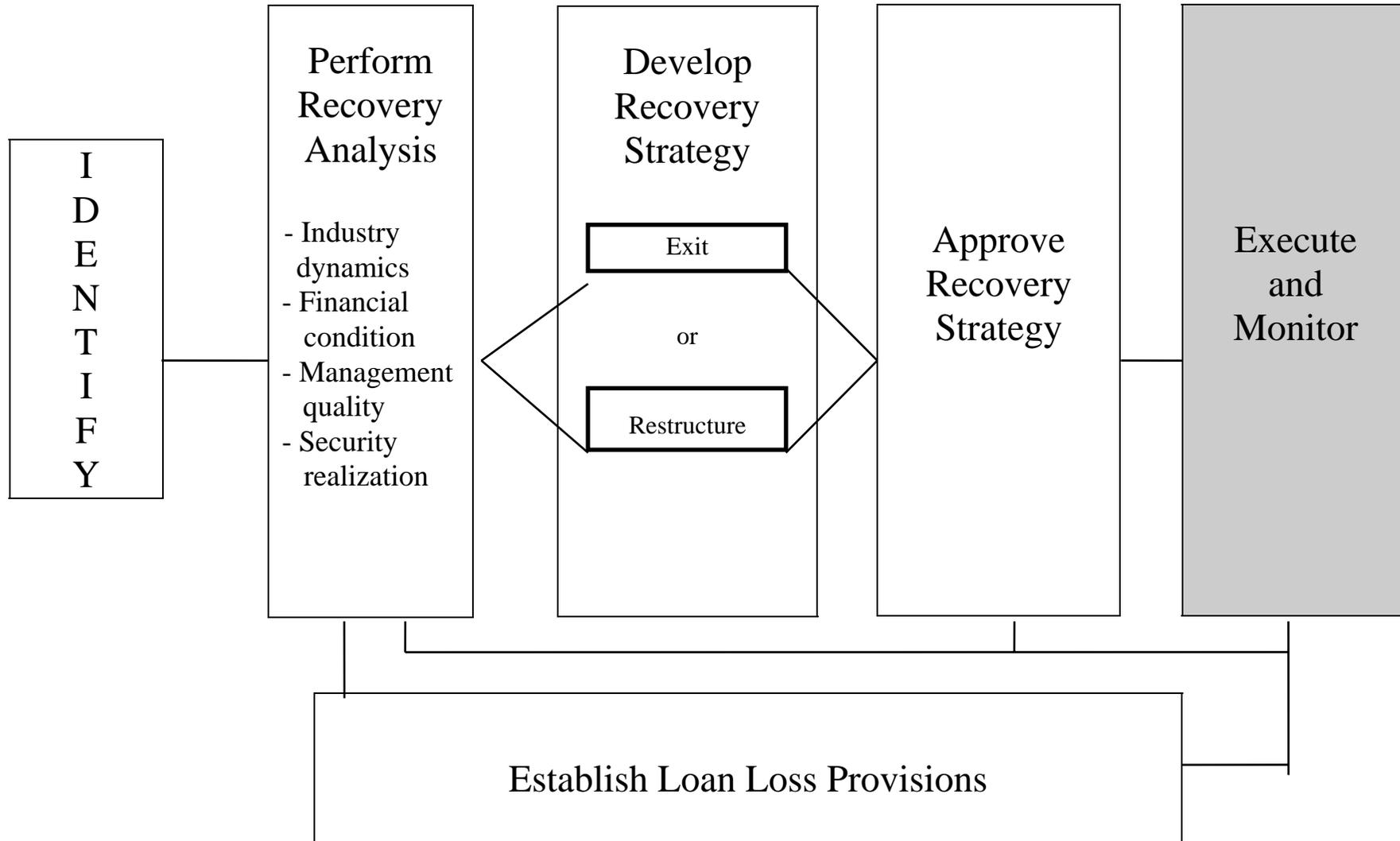
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Unit 6:
Strategy Monitoring

Problem Loan Recovery Process



Objective

At the end of this unit participants will be able to:

1. Identify and address recovery problems before or immediately upon occurrence.

Objective of Recovery Monitoring

Early identification and recognition of problems is critical to preventing additional losses. It:

- Allows the bank to act before problems become severe
- Allows bank to adjust strategies more quickly
- Enables development of counter-action to reduce exposure

Recovery Monitoring

Occurs at high intensity level because risk is higher than for normal customers. Why?

- Changes in creditworthiness can occur rapidly
- Quick response to changes is often required to protect the bank

Major Components of Recovery Monitoring

- Creditworthiness monitoring
- Recovery strategy monitoring

Customer Creditworthiness Monitoring

Follows the four foundations of the customer's creditworthiness

- Industry dynamics monitoring tracks changes in industry elements
- Financial condition monitoring tracks the first way out
- Management quality monitoring tracks performance in meeting commitments and action plans
- Security realization monitoring tracks the second way out

Recover Strategy Monitoring

Tracks the execution of strategies.

- Confirms action steps have been taken
- Focuses on overall strategy execution success
- Identifies the need for strategy revisions

Early Warning Signals for Monitoring Creditworthiness

Creditworthiness monitoring entails reviewing the four credit foundations for “early warnings” signals of possible problems.

- Early warning signals provide a basis for identifying potential problems before further deterioration results

- Each foundation, whether weak or strong, requires constant monitoring

- Often strong foundations weaken during strategy execution.
 - Management integrity deteriorates

 - Financial condition may deteriorate as creditor support is lost

Early Warning Signals for Monitoring Creditworthiness, continued

- Foundations improve
 - Security realization strengthened by pledge of additional security
 - Financial condition may improve by restructuring the balance sheet

Examples of Early Warning Signals

Foundation	Warning Signals
Industry Dynamics	<ul style="list-style-type: none">• Intensifying competition• Loss of market to substitutes• Supply of disruptions/price increases• Non-competitive cost structure• Loss of market share• Unusual asset/liability• Below average performance• Decline in net income
Financial Condition	<ul style="list-style-type: none">• Decline in liquidity• Increase in leverage• Deviation in borrowing patterns• Lateness in payment• Rumors of liquidity problems• Poor account fluctuation

Examples of Early Warning Signals, continued

Foundation		Warning Signals
Management Quality	—————	<ul style="list-style-type: none"> • Changes in key executives/owners • Evidence of weak controls • High staff turnover • Evasive answers/delayed data, etc. • Loss of control over collateral • Evidence of high stress • Evidence of self-dealing • Evidence of poor business decisions • Reputation declining • Expired documentation • Changes in market values/marketability
Security Realization	—————	<ul style="list-style-type: none"> • Increases in liquidation costs • Evidence of collateral liquidation • Legal process lengthening

Recovery Strategy Monitoring

Recovery strategy monitoring:

- Entails evaluating progress against plan
 - Monitors execution
 - Monitors customer progress against plan
 - Documents progress and variances from plan
- Evaluates need for strategy revisions
 - Assesses implementation success
 - Evaluates opportunities for improving strategy
 - Identifies when action steps for entire strategy may need to be changed

Inform Senior Management

It is critical senior management is informed:

- Provides a steady progress update to gauge creditworthiness and strategy effectiveness
- Allows senior management to assess possible modification in remedial action
- May trigger prompt government action

Alternative Strategy Selection

Primary strategy may be unsuccessful:

- Lowest risk strategy to the bank is often proposed first
- Customer may resist first strategy proposed

Conditions change requiring new strategies:

- Changes can be positive or negative
- New strategies may be tailored more to the new conditions

Example of Critical Changes in Strategy

- Reversing restructure/exit strategy
- Allowing loan to remain unpaid and not accruing interest
- Change interest rate charged
- Extending maturities
- Charging off principal
- Increasing exposure
- Reporting suspected fraud
- Reducing, forgiving principal or interest
- Giving up whole or part collateral

Discussion

1. What is the key objective of recovery monitoring?
2. If monitoring is conducted properly, how are additional losses prevented?
3. What are the two key components of recovery monitoring?
4. If a warning signal is identified, list possible actions to be taken by the bank.

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Unit 7:
Case Study Discussion

FINANCIAL SPREADSHEETS

Company Name: Machine Engineers.

Amounts in: 000's ECU

Date (Day, Month, Yr):

1996

1997

1998

1999

Balance Sheet

DESCRIPTION	AMOUNT	%	AMOUNT	%	AMOUNT	%	AMOUNT	%
ASSETS								
Fixed Assets								
Land and Construction			122,099		160,392			
Equipment			34,331		50,174			
Technical means and equipment for accounting Vehicles								
Intangible assets	113		81		72			
Other long-term assets	192,914		28,523		27,679		229,366	
Current Assets								
Currency	2,095		4,601		1,777		75	
Raw materials reserve	27,719		21,372		13,733		10,924	
Unfinished production	10,256		15,992		23,371		32,146	
Finished articles	95		95		95			
Clients' debts	39,926		48,713		43,459		33,208	
Other short-term assets	1,501		1,637		1,533		10	
Other Assets								
	99,696		199		136			
TOTAL ASSETS	374,315		277,643		322,421		305,729	
LIABILITIES								
Owned Capital								
Capital	215,848		205,777		209,214		148,227	
Reserves								
Undistributed profit	111,602		6,623		-60,987		(84,515)	
Borrowed Capital								
Short-term debt								
To suppliers	14,802		31,834		60,508		68,224	
To the budget								
To the employees								
To social insurance companies							102,428	
To the banks								
Other	25,789		9,564		82,345		20,838	
Long-term debt								
To the banks			20,082		24,592		33,075	
Other			300		1,283		6,560	
Accruals and deferred income								
	6,274		3,651		5,466		10,892	
TOTAL CAPITAL	374,315		277,831		322,421		305,729	

FINANCIAL SPREADSHEETS

Company Name: Machine Engineers.

Currency: 000's ECU

Amounts in: 000's ECU

Date (Day, Month, Yr):

1998

1999

2000

Profit and Loss

DESCRIPTION	AMOUNT	%	AMOUNT	%	AMOUNT	%	AMOUNT	%
Income from the main activity	97,704		102,124					
Total input of the main activity								
Direct input, Total								
Raw materials	47,949							
Outside Services	12,786							
Direct Salary (Social taxes included)	65,469							
Direct Depreciation expenses	14,022							
Other direct expenses	<u>3,962</u>							
Total cost of goods sold	144,188		149,143					
Gross profit	(46,484)		(47,019)					
Overhead expenses, Total								
Salary and social taxes								
Energy system of the enterprise								
Depreciation								
Other activity expenses								
Profit from the main activity								
Other Activity								
Revenue								
Expenses	1,492		12,773					
Profit								
Financial and investment activities								
Revenue								
Expenses	13,299		20,470					
Profit								
Extraordinary gains and losses	(3,705)		(1,287)					
Profit before taxes	(64,980)		(81,549)					
Profits tax	3,993		(2,966)					
Net profit	(60,987)		(84,515)					
Dividends								
Retained profit								

FINANCIAL SPREADSHEETS

Company Name: Meble Express Ltd.	Currency: 000's ECU	
Amounts in: 000's ECU, Date (Day, Month, Yr):	1998	1999
Cash Flow Statement - Direct Method		
DESCRIPTION		
Sales-Net	1	102,124
(Inc) Dec in Receivables	2	11,319
	3	
Cash from Sales (1+2)	4	113,443
	5	
<i>Cost of Sales (IS)</i>	6	(144,224)
(Inc) Dec in Inventories	7	(5,416)
Inc (Dec) in Payables	8	7,716
	9	
Cash Production Costs (sum 5..9)	10	141,924
Gross Cash Margin (4+10)	11	28,481
Other Liabilities	12	5,426
<i>S,G&A Expense (IS)</i>	13	
(Inc) Dec in Prepaids	14	
Inc (Dec) in Accruals	15	(1)
Inc (Dec) Other Assets	16	136
Cash Operating Expense (sum 12..16)	17	5,561
Cash from Operations (11+17)	18	(22,920)
	19	
<i>Miscellaneous Cash Income (IS)</i>	20	9,244
<i>Income Taxes Paid (IS)</i>	21	(2,966)
Total (sum 19..21)	22	6,278
	23	
Net Cash from Operations (18+22)	24	(16,642)
	25	
<i>Interest Expense (IS)</i>	26	(20,470)
Dividends Paid/Owner Withdrawals	27	
<i>Extraordinary Loss (IS)</i>	28	(10,531)
Financing Costs (sum 25..28)	29	(31,001)
Net Cash Income (24+29)	30	(47,643)
	31	
Current Portion Long-Term Debt	32	
	33	
Total (31+32)	34	
Cash after Debt Amortization (30+34)	35	(47,643)
Capital Expenditures	36	(8,741)
	37	
Total (36+37)	38	
Financial Surplus (Requirements) (35+38)	39	(56,384)
Special Fund	40	
Inc (Dec) Short-Term Debt	41	
Inc (Dec) Long-Term Debt	42	13,760
Inc (Dec) Equity	43	
Other Liabilities	44	40,921
Total External Financing (sum 40..44)	45	54,681
	46	
Cash after Financing (45+39)	47	1,703
Actual Change in Cash		0

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Unit 8:
Summary

Purpose

1. Participants will discuss how to apply the key elements of the Problem Loan Management course to their jobs.

Objective

1. At the end of this unit, participants will be able to summarize the general principles related to problem loan management.

Key Elements of Problem Loan Management

- Identify early problem loans, ensure they are managed by the most appropriate resources and ensure additional exposure incurred is controlled to the advantage of the bank.
- Identify and assess credit problems and evaluate the bank's position to facilitate recovery strategy development.
- Maximize recoveries through development of appropriate action plans.
- Gain approval of strategies and action plans.
- Monitor recovery strategies to identify and address problems before they occur.

Exercise

Part 1

1. List 5 key principles you want to remember from the course and apply on the job.
2. Divide into groups of 3 to 4.
3. Discuss key principles and select at least 3 items to apply on the job.
4. Present two of your items to the large group.

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